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## **APPENDIX F**

### **TAX OPINIONS AND ADVICE RE: CONSERVATION EASEMENTS AND CONSERVATION BUYER TRANSACTIONS**

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## SFC II RESPONSE

### I. Conservation Buyer Program, Question 8

#### VI. Easements, Question 17

8. Please provide a list of lawyers, accountants, and other outside counsel who have provided tax opinions or other tax advice to TNC with respect to the tax consequences to TNC or other parties to TNC's CBP transactions (whether with respect to actual or hypothetical transactions); please provide a copy of such opinions and written advice.
17. Please provide a list of lawyers, accountants and other outside counsel who have provided tax opinions or other tax advice to TNC with respect to the tax consequences to TNC or other parties regarding the acquisition or granting by TNC of conservation easements or similar conservation restrictions (whether with respect to actual or hypothetical transactions); please provide a copy of such opinions or written advice.

Firm/Contact	Address	Opinion	Attachment
Deloitte & Touche LLP	555 12 <sup>th</sup> Street, NW, Suite 500 Washington, DC 20004-1207	San Rafael Cattle Company, Inc.	Letter dated December 14, 1998 to Michael Dennis from Deloitte & Touche LLP.
Holden, Kidwell, Hahn & Crapo, P.L.L.C. [REDACTED]	U.S. Bank Building 330 Sioup Avenue Third Floor P.O. Box 50130 Idaho Falls, ID 83405	Centennial Valley (P.L.L.C.), Montana [REDACTED]	Letter dated 10.15.02 to [REDACTED] and [REDACTED] from [REDACTED]; Other attachment dated 10.4.02
Deloitte & Touche LLP [REDACTED] Tax Partner		Little Rapid - Beaver Creeks sale to [REDACTED]	Letter dated 11.23.94 to [REDACTED] from [REDACTED]
Ernst & Young LLP [REDACTED]	Suite 2100 400 West Market Street Louisville, KY 40202	[REDACTED] Purchase	Letter dated 8.23.99 to [REDACTED] ([REDACTED], Inc.) from [REDACTED]
Jerry J. McCoy Attorney At Law	1050 Connecticut Avenue, NW Suite 1200 P.O. Box 66491 Washington, DC 20035-6491	Particular form of transaction used by TNC in its land conservation activities.	Letter dated 1.20.03 to Michael Dennis from Jerry J. McCoy
		Request for Outside Counsel re: Davis Mountains Ranch Conservation Project, TX	Letter dated 1.29.97 to [REDACTED] from [REDACTED]

## SFC II RESPONSE

### I. Conservation Buyer Program, Question 8

#### VI. Easements, Question 17

Firm/Contact	Address	Opinion	Attachment
Step toe & Johnson [REDACTED]	1330 Connecticut Avenue, NW Washington, DC 20036-1795	Response to request dated 1.29.97 re: Davis Mountains Ranch Conservation Project, TX	Letter dated 3.10.97 to [REDACTED] from [REDACTED]
Step toe & Johnson	1330 Connecticut Avenue, NW Washington, DC 20036-1795	Letter Ruling 200213021 (12.14.01) CCH IRS Letter Rulings Report No. 1309, 04-03-02 IRS REF: Symbol: CC:ITA:2-PLR- 135425-01	Fax dated 5.7.02 from Step toe & Johnson (no recipient listed)
Faison Stone [REDACTED]	816 Congress Avenue, Suite 1670 Austin, TX 78701	After tax net cost analysis	Fax dated 1.30.97 to [REDACTED] from [REDACTED]; Attachment dated 1.29.97, memo to [REDACTED] from [REDACTED]
Step toe & Johnson [REDACTED]	1330 Connecticut Avenue, NW Washington, DC 20036-1795	Use of LLC in Connection with [REDACTED]/TNC Eastern Shore Transaction	Fax memorandum dated 6.7.01 to [REDACTED] and [REDACTED] from [REDACTED] [REDACTED] and [REDACTED]
Pinna, Johnston & Burwell, PA [REDACTED]	2601 Oberlin Road, Suite 100 Oaks of Fairview Raleigh, NC 27608	[REDACTED] L.L.C. Contract	Letter dated 5.22.00 to [REDACTED] from [REDACTED]
Step toe & Johnson [REDACTED]	1330 Connecticut Avenue, NW Washington, DC 20036-1795	Deductibility of the Amounts Paid for Property Purchased from a Charity at a premium	Fax letter dated 9.26.02 to Michael Dennis and [REDACTED] from [REDACTED]
Choate, Hall & Stewart [REDACTED]		Status of Negotiations with Herring Creek Acquisition Company Regarding "Tax Make-Whole Payment"; Attachments	Memorandum dated 10.18.01 to [REDACTED] from [REDACTED]-III. PC
Deloitte & Touche LLP [REDACTED]	555 12 <sup>th</sup> Street, NW, Suite 500 Washington, DC 20004-1207	[REDACTED] Corporation Questions	Letter dated 5.15.00 to [REDACTED] from [REDACTED]

# SFC II RESPONSE

## I. Conservation Buyer Program, Question 8

### VI. Easements, Question 17

Firm/Contact	Address	Opinion	Attachment
[REDACTED]		The Forest Bank, LLC U. S. Federal Income Tax Opinion – H&W Tax Opinion	Letter dated May 2001 to The forest Bank, LLC, c/o TNC from [REDACTED] Van Deusen
Knight & Masar Attorneys at Law [REDACTED]	300 The Florence 1111 N. Higgins Avenue, 59802 P.O. Box 8957 Missoula, MT 598078957	Arrow Ranch Conservation Easement	Letter dated 6.13.95 to [REDACTED] from An [REDACTED]
Deloitte & Touche [REDACTED]	50 Fremont Street San Francisco, CA 94105	TNC- Meteteetsee River – Pitchfork Ranch • Like Kind Exchanges – Summary of Tax Issues	Memorandum dated 1.17.01 from [REDACTED] to TNC
Deloitte & Touche [REDACTED]	701 "B" Street, Suite 1900 San Diego, CA 92101	TNC- Meteteetsee River – Pitchfork Ranch • Acquisition of property from Langley Hall Ranch LLC	Memorandum dated 2.23.01 to [REDACTED] from [REDACTED]
Holland & Hart LLP [REDACTED]	555 Seventeenth Street Suite 3200 Denver, CO 80202-3979	Other Parties – Meteteetsee River – Pitchfork Ranch/Wilson Tract	Confidential Memorandum dated 10.26.01 to [REDACTED] from [REDACTED], attachment, email to [REDACTED] from [REDACTED] re: Pitchfork Ranch transaction/Wilson tract
Deloitte & Touche [REDACTED]	701 "B" Street Suite 1900 San Diego, CA 92101	TNC - Bighorn Foothills – PK Ranch • Soldier Creek Preserve (tax consequences to TNC of SCP's present intent to sell appreciated assets followed by a complete liquidation)	Email dated 4.11.03 to [REDACTED] from [REDACTED] attachment: letter dated 4.11.03 to TNC from [REDACTED] re: Soldier Creek Preserve

# SFC II RESPONSE

## I. Conservation Buyer Program, Question 8 VI. Easements, Question 17

Firm/Contact	Address	Opinion	Attachment
Deloitte & Touche LLP [REDACTED] Manager, Tax Services [REDACTED] Tax Senior	701 "B" Street Suite 1900 San Diego, CA 92101	TNC - Bighorn Foothills - PK Ranch • PK Ranch Distribution of Earnings & Profits	Original email dated 6.12.00 from [REDACTED] to [REDACTED]; email forward dated 6.13.00 from [REDACTED] to [REDACTED]; email response dated 6.13.00 to [REDACTED] from [REDACTED] attachment: fax letter dated 6.12.00 from [REDACTED] to [REDACTED] (includes blank IRS Form 8109); email dated 6.12.00 from [REDACTED] to [REDACTED], forward of email to [REDACTED], [REDACTED] Memo dated 6.1.00 to TNC-Fax File from [REDACTED]
Deloitte & Touche LLP [REDACTED] Manager, Tax Services	701 "B" Street Suite 1900 San Diego, CA 92101	TNC - Bighorn Foothills - PK Ranch • Acquisition of PK Ranch Company (tax due diligence)	Letter dated 12.10.99 to [REDACTED] from J [REDACTED]; attachment: letter dated 11.29.99 to TNC from [REDACTED]
Deloitte & Touche LLP J [REDACTED] Manager, Tax Services	701 "B" Street Suite 1900 San Diego, CA 92101	TNC - Bighorn Foothills - PK Ranch • Original tax issues summary and calculations	Fax memorandum dated 11.16.99 to [REDACTED] from [REDACTED]; attachments: (1) dated 11.16.99, Interest Deductible; (2) dated 11.16.99, Interest Non-Deductible; (3) letter dated 12.10.99 to [REDACTED] from [REDACTED]

## SFC II RESPONSE

### I. Conservation Buyer Program, Question 8

#### VI. Easements, Question 17

Firm/Contact	Address	Opinion	Attachment
Deloitte & Touche LLP [REDACTED]	50 Fremont Street San Francisco, CA 94105	TNC - Bighorn Foothills - PK Ranch • Soldier Creek Preserve 1031 Exchange	Email dated 4.2.01 to [REDACTED] from [REDACTED], email response dated 4.2.01 from [REDACTED] to [REDACTED], email forward dated 4.2.01 to [REDACTED] from [REDACTED], [REDACTED]
McCutchen, Doyle, Brown & Enersen, LLP [REDACTED]	Three Embarcadero Center San Francisco, CA 94111-4067	Amending Conservation Easements	Letter dated 3.15.01 to Michael Dennis and [REDACTED] from [REDACTED] and [REDACTED]
Stephoe & Johnson [REDACTED]	1330 Connecticut Avenue, NW Washington, DC 20036-1795	Purchase/Donation	Draft letter dated 1.31.92 to [REDACTED] from [REDACTED]
Wilson & Company [REDACTED]	P.O. Box 1120 Sumerset, KY 12501	Lost Island, Inc. Clear Lake Club, Inc. Axe Lake Swamp	Letter dated 3.2.99 to [REDACTED] from [REDACTED], letter dated 7.19.99 to [REDACTED] from [REDACTED], memorandum dated 8.10.98 to [REDACTED] from [REDACTED]
Issacson, Rosenbaum, Woods & Levy, PC [REDACTED]		May 23, 2002 Memorandum re: Availability of Colorado conservation Income Tax Credits	Email dated 9.27.02 to Mike Dennis, [REDACTED] from [REDACTED], Letter dated 9.27.02 to [REDACTED] from [REDACTED]

**Deloitte &  
Touche LLP**



**CONFIDENTIAL**

Suite 500  
555 12th Street, NW  
Washington, D.C. 20004-1207

Telephone: (202) 878-5600  
Facsimile: (202) 878-5309

December 14, 1998

Mr. Michael Dennis, Esq.  
General Counsel  
The Nature Conservancy  
4545 North Fairfax Drive  
Suite 100  
Arlington, VA 22203-1606

Dear Mr. Dennis:

This is in reply to your request for an opinion regarding the tax implications of the proposed conversion of San Rafael Cattle Company, Inc. from a taxable entity to a tax-exempt organization under Internal Revenue Code (IRC) §501(c)(2).

In rendering this opinion, we have (with your permission) reviewed and relied upon, among other things:

- a) The facts, representations, and assumptions summarized below; and
- b) Your letters to us dated September 8, 1998, and the exhibits therein; and
- c) Representations from Morrison & Hecker, LLP, legal counsel, dated December 10, 1998.

#### FACTS AS REPRESENTED TO US

The San Rafael Cattle Company, Inc. (SRCC) is currently a Subchapter C corporation for federal and state income tax purposes. The Nature Conservancy, which is recognized as a tax-exempt organization under §501(c)(3), desires to purchase the stock of this corporation, and convert the corporation to an IRC §501(c)(2) title holding company for the purposes of preserving the natural beauty of the land and surrounding San Rafael Valley in Arizona.

You have represented to us that The Nature Conservancy will not incur any indebtedness with regard to the purchase of the stock of SRCC, that SRCC does not have any debt that will constitute "acquisition indebtedness" within the meaning of IRC §514(c), and that SRCC does not carry on any activities that would give rise to unrelated business taxable income as defined under IRC §512.

In addition, The Nature Conservancy is currently negotiating with the State of Arizona for the sale of an easement on real property that is held by SRCC.

#### ISSUES

1. Will the conversion of SRCC to a tax-exempt organization be subject to tax?

**Deloitte Touche  
Tohmatsu  
International**

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2. Will the income earned by the SRCC, including any future sale of assets, be considered unrelated business income under IRC §512?
3. What will be the effective date for the conversion to an IRC §501(c)(2) title holding company?

### CONCLUSIONS

1. The conversion to a tax-exempt title holding company should not be subject to tax.
2. If all of SRCC's assets will be utilized in The Nature Conservancy's tax-exempt purpose as represented, any income earned, including gains from sale of assets, will generally be exempt from tax.
3. The effective date for the conversion to tax-exempt status should be the date the governing documents are amended and the application for exemption is filed (for federal and state purposes).

### LAW & ANALYSIS

#### Conversion to a Tax-exempt Organization

Generally, a distribution of assets from a taxable subsidiary to a tax-exempt parent, not in complete liquidation, will result in gain recognition at the subsidiary level as if the property or other distributed assets were sold to the distributee at the fair-market value of the assets under IRC §311(b). As such, if SRCC distributed the title to the land owned in the San Rafael Valley to The Nature Conservancy, SRCC would be required to recognize the gain on the land.

Secondly, if SRCC transferred the land outright to the parent, the transfer would be considered a dividend under IRC §316(a). Any amounts transferred without consideration by a taxable corporation to its sole stockholder, an organization exempt from federal income tax are considered dividends to the parent. Under this type of transfer, SRCC would be required to recognize income equal to the fair-market value, less the adjusted basis in the property transferred, and would be required to pay taxes on the difference similar to that discussed above.

SRCC will not distribute assets to its tax-exempt parent prior to conversion to tax-exempt status. SRCC will be converted to an IRC §501(c)(2) title holding company. As such, legal counsel has reviewed the activities of SRCC to determine that they meet the qualifications as a tax-exempt holding company under IRC §501(c)(2).

The IRS could argue that §337(b)(2) applies to this transaction, which would make the conversion an immediately taxable event. IRC §337(b)(2) states that gain or loss would be recognized where the distributee is an exempt organization. We believe however that the IRS should lose this argument based upon the characterization of the conversion discussed below.

On January 13, 1997, the IRS released proposed regulation §1.337(d)-4. The regulations would generally treat a change in a corporation's tax status as an asset transfer. (Prop. Reg. 1.337(d)-4(a)(2)). There are a number of exceptions and an anti-abuse rule, which are important but not relevant here. The proposed regulations will be effective "30 days after publication in the Federal Register of these regulations as final regulations..." (Prop. Reg. 1.337(d)-4(e)). However, as of today, we have not seen the regulations published in final form. The proposed regulations have a prospective effective date. It is our view that a corporation that amends its articles and by-laws, and files its application for exemption prior to the issuance of the final regulations, should not be

**Deloitte &  
Touche LLP**

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subject to those regulations, even if the exemption application is granted after the regulations are effective. We believe that under IRC §361, a conversion from a taxable to a tax-exempt organization would not be considered a deemed liquidation, as SRCC would be amending its corporate charter rather than liquidating and reincorporating.

#### Unrelated Business Income

IRC Regulation §1.501(c)(2)-1 states, "A corporation described in §501(c)(2) and otherwise exempt from tax under §501(a) is taxable upon its related business taxable income... Since a corporation described in §501(c)(2) cannot be exempt under §501(a) if it engages in any business other than that of holding title to property and collecting income therefrom, it cannot have unrelated business taxable income..." As a result, there is a prohibition on the receipt of unrelated business taxable income (other than that which could result from holding debt-financed rental property). Therefore, SRCC can only hold title to assets for its tax-exempt parent, collect income therefrom, and remit the income less expenses to its parent. However, under IRC Reg. §1.501(c)(2)-1(a), a §501(c)(2) tax-exempt organization is allowed to have unrelated taxable income, if it is due to IRC §514.

Under IRC §514, income from debt-financed property generally results in unrelated business income. Reg. §1.514(a)-1(a)(3) defines average acquisition indebtedness as the average amount of the outstanding principal indebtedness during that portion of the taxable year the property is held by the organization. Under IRC §514(c)(7), if property is sold or otherwise disposed of, average acquisition indebtedness is defined as the highest amount of the acquisition indebtedness with respect to such property during the 12-month period ending with the date of the sale or other disposition.

IRC §514(b)(1)(A)(i) excludes from the definition of debt-financed property assets held for an exempt organization's tax-exempt purpose. Reg. §1.514(b)-1(c)(2)(i) states that property owned by an exempt organization and used by a related exempt organization shall not be treated as debt-financed property if used in furtherance of the related organization's exempt purpose. Reg. §1.514(b)-1(c)(2)(ii)(a) goes on to state that "related organizations" for purposes of the above stated rule include a title holding company exempt under IRC §501(c)(2) and its tax-exempt parent. You have further represented to us that all of SRCC's assets will be utilized in the Nature Conservancy's tax-exempt purpose.

#### Effective Date of Tax-Exempt Status

The actual conversion for Federal purposes would be accomplished by amending the articles of incorporation and by-laws and filing Form 1024, *Application for Recognition of Exemption*. Arguments can be made that the conversion occurs on any one of three dates: (1) the date that the corporation's articles of incorporation and bylaws are amended, (2) the date that the application for exemption is filed, or (3) the date that the exempt determination letter is granted.

We believe that the conversion occurs at the time that the application for exemption is filed, unless no application for exemption is required. The proposed regulations discuss the time when an organization is deemed to have exemption under certain exceptions for changes of status within three year periods, and they look to the filing of an application for recognition of exemption, not the later date that exemption is granted. (Prop. Reg. §1.337(d)-4(a)(3)(ii)).

We believe that the date of the conversion is not the earlier amendment of articles and bylaws nor the later date that the exempt determination letter is granted. Amending a corporation's articles and bylaws alone will usually not change a taxable corporation to a tax-exempt one, unless no application for exemption is required. Likewise,

**Deloitte &**

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since the determination of exempt status generally relates back to the date that the exemption application was filed, and in some cases earlier, IRS issuance of the determination letter should not be the date of the conversion.

Therefore, it is our contention that from the date of amendment of the articles of incorporation and by-laws and the filing of Form 1024, SRCC would qualify as a tax-exempt organization.

Other Considerations

SRCC's legal counsel will review the amendments to the articles and by-laws for state law specific provisions.

Additionally, Reg. §1.501(c)(2)-1(b) states that IRC §501(c)(2) organizations cannot accumulate income. Therefore, SRCC must turn over the entire amount of such income, less expense, to its parent, an organization which is exempt from tax under IRC §501(a).

This opinion is based solely upon:

- a) the representations, information, documents, and facts we have included or referenced in this opinion letter;
- b) our assumption (without independent verification) that all of the representations and all of the originals, copies, and signatures of documents reviewed by us are accurate, true, and authentic;
- c) our assumption (without independent verification) that there will be timely execution and delivery of an performance as required by the representations and documents;
- d) the understanding that only the specific Federal income tax issues and tax consequences opined upon herein are covered by this tax opinion, and no other federal, state, or local taxes of any kind were considered;
- e) as a tax-exempt title holding company, San Rafael Cattle Company, Inc. will not engage in any trade or business, other than holding title to property for its tax-exempt parent;
- f) the Nature Conservancy is tax-exempt under Federal and Arizona law;
- g) the law, regulations, cases, rulings, and other tax authority in effect as of the date of this letter. If there are any significant changes of the foregoing tax authorities (for which we shall have no responsibility to advise you), such changes may result in our opinion being rendered invalid or necessitate (upon your request) a reconsideration of the opinion;
- h) your understanding that this opinion is not binding on the IRS or the courts and should not be considered a representation, warranty, or guarantee that the IRS or the courts will concur with our opinion;
- i) your understanding that this opinion letter is solely for your information and benefit, is limited to the described transaction, and may not be relied upon, distributed, disclosed, made available to, or copied by anyone, without prior written consent or as described herein;
- j) your representation that San Rafael will not at the time of the conversion and thereafter carry on any unrelated trade or business (with minor exceptions not relevant here) or have incurred 'acquisition indebtedness' within the meaning of IRC §514(c);

**Deloitte &  
Touche LLP**

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k) your representation that the Nature Conservancy will not incur debt to finance the acquisition of the San Rafael Stock;

l) that all property held by SRCC will be utilized in the Nature Conservancy's tax-exempt purpose.

In issuing this opinion we relied solely upon representations from outside legal counsel for the Nature Conservancy that:

- a) amendments are possible under Arizona law to allow conversion to a tax-exempt title holding company without such amendments constituting a liquidation under Arizona law (we will also rely on legal counsel to prepare the filings necessary to amend the governing documents under state law);
- b) Arizona law permits a stock corporation to qualify as a tax-exempt title holding company and that appropriate application for recognition of tax exemption will be filed with the appropriate agency of the state of Arizona;
- c) as a tax-exempt title holding company, SRCC's sole purpose per its charter will be to hold title to property for its tax-exempt parent, and will remit any net income from the property to its parent, on an annual basis; and
- d) San Rafael Cattle Holding Company, Inc. will be a direct subsidiary, through 100% stock ownership by the Nature Conservancy.

If you have any questions concerning this opinion please contact [REDACTED]

Very truly yours,

*Deloitte + Touche, LLP*

Deloitte & Touche LLP

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**Deloitte &  
Touche LLP**

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Of Counsel  
Fred J. Hahn

October 15, 2002

VIA TELEFAX NO. (406) 587-6086

Mr. Tim Swanson  
The Nature Conservancy

VIA TELEFAX NO. (303) 541-0346

Wendy Dinner, Esq.  
The Nature Conservancy

Dear Tim and Wendy:

In anticipation of our telephone conference with afternoon, I am writing to highlight some of the [REDACTED] primary concerns regarding the easement and the documentation report. Before getting to those details, let me first address the lien issue which Wendy raised last week. The taxpayer in the case which Wendy referred to received cash for a conservation easement. The [REDACTED] will exchange into other real property on a section 1031 like-kind exchange. The IRS specifically recognizes the continuing availability of the special use valuation if the property is exchanged into other property eligible for special use valuation. I do not anticipate an estate tax problem with this issue.

Of greater concern is the lien on the existing property. I expect the IRS to approve transferring the lien from the existing property to the replacement property, but I will be surprised if we are able to accomplish that within two weeks. [REDACTED], the [REDACTED]'s accountant, will arrange for this through his partner in the Helena office.

Mr. Tim Swanson  
Mrs. Wendy Dinner  
October 15, 2002  
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With the tax issues hopefully out of the way, we can address the specifics of the transaction. [REDACTED]'s and [REDACTED]'s primary concern relates to their ongoing grazing of livestock and utilization of the property in a ranching operation. They believe that they should be permitted to utilize the ranch at current and historic levels. As operators of the ranch, they have a vested interest in maintaining the quality of the property for ranching operations. They are particularly concerned about paragraph 4.A.ii. We will have to discuss at some detail the mechanism to provide them with the necessary comfort with that issue.

I am enclosing two pages which show specific provisions which we wish to discuss.

Also, there are some provisions from the Centennial Valley easement which we wish to have in these easements. They include paragraph 6.A., 6.E., 4.N., and 4.M. from the Centennial Valley easement.

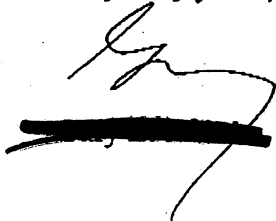
In the Centennial Valley easement under paragraph 5, TNC has 20 days from receipt of a notice of proposed activity to request additional information concerning the proposed activity. We suggest that the same 20 day provision be in the new easements.

Paragraph 7 of the Centennial Valley easement requires a 30-day notice from TNC to the grantor concerning violations, remedies, etc. The proposed agreements do not have a corresponding notice provision. We believe it is important that it be added.

Paragraph 12.C. of the Centennial Valley easement provides a mechanism for the grantor to participate in selecting a successor organization to TNC. Again, we believe this should be included in the proposed easements.

I look forward to visiting with you later.

Very truly yours,



Enclosures

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**DRAFT**

significant deterioration, the Conservancy shall so inform Grantor. In response, Grantor shall develop a Grazing and Riparian Management Plan for review and approval by the Conservancy and Grantor shall then implement the approved plan.

B. Use, maintenance, repair, and construction of new livestock handling facilities provided that these facilities are limited to a corral, loading chute, and related facilities. These structures may not be constructed in wetland basins or within 50 yards of Winslow Creek.

C. Maintenance and improvement of existing roads, and construction of new roads as may be necessary to carry out the agricultural and ranching activities as provided herein, provided, however, that all roads shall be kept to the minimum widths and minimum level of improvement necessary to accomplish the purpose of the road.

D. Maintenance, repair, and reconstruction of existing fencing and <sup>intentionally</sup> construction of new fences. New or reconstructed boundary or pasture-division fences may not exclude or prevent wildlife from moving through the Property, but other fencing may exclude wildlife from, newly-seeded areas and temporary vegetative restoration areas. Present fencing may be replaced with similar types of fencing in approximately the same location.

E. Use of agricultural chemicals, including fertilizers, pesticides, herbicides, insecticides and rodenticides. The use of such agents shall be conducted in such a manner as to minimize adverse effects upon the natural values of the Property and the natural ecosystem. Aerial spraying of chemical agents requires advance approval by the Conservancy.

F. Introduction of biological weed and pest control agents.

*At 3.6. from Corral Creek — raising harvesting, hay & ~~not historical~~ in Bl. ~~to verify~~ ~~to even~~ ~~to verify~~*

G. Removal of surface sand and gravel in limited quantities, for use solely in ranch operations consistent with historical practices. Under no circumstances is any commercial use of sand or gravel located on the Property permitted by this Easement, nor may any sand or gravel be mined for any purpose, either commercial or non-commercial. All sand and gravel extraction permitted hereunder shall have only limited, localized impacts, and shall be suspended, if the Conservancy determines such removal impairs any of the Conservation Values protected by this Easement.

H. Use, maintenance, repair, and reconstruction of existing agricultural water facilities, as documented in the Report and with prior notice and approval of the Conservancy, the development of new water resources and facilities, including the diversion, withdrawal and use of water, consistent with valid water rights, for wildlife habitat enhancement and other uses provided for herein; provided that any maintenance, repair, reconstruction, construction or development activities do not cause significant or long-term impairment of water quality or riparian values.

I. Construction of utility systems for the uses permitted in this Easement.

To: Allan Beezley  
From: Ben Pierce

**Deloitte &  
Touche LLP**



November 23, 1994

Mr. Benjamin C. Pierce, Director  
Wyoming Chapter  
The Nature Conservancy  
258 Main Street, Suite 20  
Lander, Wyoming 82520

Dear Ben:

The following is in response to your questions regarding the need for the allocation of the selling price of Mr. [redacted]'s ranch to the various components set forth in the Addendum to the Option Agreement.

Because the tax law requires an allocation of consideration received upon the sale of multiple assets in order to determine a taxpayer's gain or loss (see, for example, section 1060, IRC) a tremendous amount of time and effort was expended to determine the appropriate allocation to the assets sold. Treas. Reg. Sec. 1.1034-1(c)(3) also requires that an allocation be made for purposes of gain computation when part of a property was used by a taxpayer as his principal residence (as was the case with Mr. [redacted]) and part was used for other purposes. The allocation and resulting gain/loss calculations were based on previously appraised values of the separate and distinct assets comprising the ranch as set forth in the appraisal prepared by Mr. [redacted] dated October 26, 1994.

Although the appraisal specified the fair market values of the various portions of Mr. [redacted]'s ranch, it could not, and did not, document the dollar amount for which Mr. [redacted] actually sold his assets. Such documentation had to be provided by means of an allocation (not an appraisal) entered into between the buyer and seller, because the selling price was at a substantial discount below fair market value. This is normal business practice in most commercial transactions wherein more than one kind of asset is changing hands.

If you have any questions or if I can be of further assistance, please do not hesitate to call me at (303) 837-3207.

Sincerely,

[redacted]  
Tax Partner

Deloitte Touche  
Tohmatsu  
International

add to your review  
↓

We appreciate you signing the appraisal.  
TNC agreed to the allocation set forth  
in the addendum to option agreement  
based on the values established in Mr.  
[redacted]'s appraisal & we do not have any  
other information (either self-generated or  
provided by other appraisers) concerning  
such allocation of value.

#143

Little Rapid - Beaver Creek  
Sale to [redacted]  
TNC

SENT BY:

8-23-99

11:00

11:00

**ERNST & YOUNG LLP**

■ Suite 2100  
400 West Market Street  
Louisville, Kentucky 40202

■ Phone: 502 585 1400  
Fax: 502 584 4221

August 23, 1999

**DRAFT**

FOR DISCUSSION PURPOSES ONLY

Dear [REDACTED]

I have spoken with [REDACTED], Regional Counsel of The Nature Conservancy, on a few occasions over the past month about your proposed exchange of land. From my previous discussions with you I understand that you are prepared to give The Nature Conservancy a piece of property valued in excess of \$300,000 in exchange for which you will receive another piece of property valued at approximately \$270,000. In addition, you will grant a conservation easement on the property which you are going to receive that will significantly affect your possible use of that land in the future.

It appears that your exchange of land will create a tax deferred like-kind exchange, as well as a charitable contribution. In order to qualify as a like-kind exchange, a taxpayer must swap property held for investment or business use for similar property. Your exchange of property appears to meet this requirement, as pieces of land would generally be considered "like-kind" property. It is our understanding that both your current piece of property and the property which you will receive will both be held for investment and/or farming.

When two unrelated taxpayers exchange property, it is generally assumed that the pieces of property have similar fair market values. In this case, there will be valuations showing that the land you are surrendering is worth significantly more than the land you are receiving (with or without the conservation easement). Because of the value you are giving up, you will be entitled to a charitable contribution. There are two components to this charitable contribution; the first is the excess of the value of the surrendered property over the value of the received property (not considering the easement), the second is the decrease in the value of the land you receive as a result of the granting of a conservation easement.

A taxpayer can receive a charitable contribution deduction for the contribution of a "qualified conservation contribution" provided that the contribution is of a qualified real property interest made to a qualified organization and is made exclusively for conservation purposes. A restriction (granted in perpetuity) on the use of land is a qualified real property interest as defined in the Internal Revenue Code. In addition, the Nature Conservancy has represented to you that they are a qualified organization as

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August 23, 1999

defined in IRC §170(h)(3), and the granting of this easement is exclusively for conservation purposes. As such, you seem to meet all of the requirements for claiming a charitable deduction for the granting of a conservation easement.

*we can hold up on date*

In order to support the value of the contribution you have made, appraisals must be performed on the relevant property no more than 60 days prior to the contribution. A valuation would be needed on the property you receive as well as the property you relinquish. Generally you would be responsible for the cost of the appraisal on the property which you are giving up. The value of the land you receive would need to be appraised both with the easement and without the easement, to determine the value of said easement.

Perhaps the easiest way to structure this transaction would be to transfer the properties and simultaneously grant a conservation easement on the property you receive. This should qualify as a like-kind exchange as both pieces of property are held for investment and/or business use (farming). The excess of the value of your land given up over the value of the land received, including the conservation easement, should be treated as a charitable contribution. This transaction could be viewed in two ways, with each yielding the same tax answer. Firstly, this could be viewed as a swap of your land for land that is significantly lesser in value, due in part to the conservation easement as well as other factors. Secondly, this could be viewed as a swap of your land for land that is lesser in value due solely to size, location, condition, etc. of the land, followed by a contribution to the Nature Conservancy of the conservation easement. Either way, the result should be the same: a like-kind exchange of property coupled with a charitable contribution equal to the value of the land you surrendered less the value of the land you received, including the conservation easement.

A few points for you to keep in mind should be mentioned. ~~It should be mentioned that~~ the land you are to receive was once leased for oil and gas production. A contribution deduction is not allowed for a conservation easement if mineral extraction is permitted on that property. According to ~~the previous owners~~, the previous owners of the land will provide affidavits asserting that all oil and gas leases on this property have terminated and/or expired. In addition, it should be noted that taking a mortgage on the land you are going to receive could also jeopardize your charitable contribution deduction unless the mortgagee takes a subordinate position to the conservation organization.

Another point to keep in mind is the utilization of this charitable contribution in your income tax return. Deductions for contributions of capital gain property (which your land would constitute) are limited to 30% of a taxpayer's adjusted gross income for any tax year. Any excess that cannot be deducted in the year of contribution can be carried over and deducted in a subsequent tax year. Such a carryover would expire after five years if not fully utilized.

**ERNST & YOUNG LLP**

~~CONFIDENTIAL~~

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August 23, 1999

I hope I have presented the relevant issues clearly to you related to your swap of land and related charitable contribution. If you should have any questions, please do not hesitate to contact me.

Sincerely,

~~[Redacted Signature]~~  
~~[Redacted Name]~~  
~~[Redacted Title]~~

**JERRY J. McCOY**  
ATTORNEY AT LAW

1050 CONNECTICUT AVENUE, N.W., SUITE 1200  
POST OFFICE BOX 66491  
WASHINGTON, D.C. 20035-6491

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FAX (202) 466-6942

January 20, 2003

Michael Dennis  
General Counsel  
Suite 100  
4245 North Fairfax Drive  
Arlington, VA 22203-1606

Dear Mike:

This is in response to your request for my comments on a particular form of transaction used by The Nature Conservancy ("TNC") in its land conservation activities.

You also asked for a curriculum vitae showing my qualifications to comment on such a matter, and that is attached. As noted there, I have practiced tax law (with a specialty in charitable tax planning) for more than thirty years, teach courses in the subject at two national law schools, and have written widely in the field (including a book on family foundations and two monthly newsletters, Charitable Gift Planning News, and Family Foundation Advisor).

The Subject Transaction

The transaction you described is a typical land trust technique for acquiring, protecting and reselling tracts of land with significant conservation values. The transaction generally proceeds as follows:

In Step One, the land trust purchases the land, generally paying an amount equal to the fair market value of the land. (If the original owner were inclined to donate the land to the land trust, or sell it for less than full value, he or she would probably be willing to proceed with the protection of the land without involving the land trust in the sale transaction at all.)

In Step Two, the land trust encumbers the land with a negative restriction or "conservation easement," thereby permanently limiting its use and assuring it will not be developed or otherwise converted to uses that would be injurious to the conservation values being protected. As when an individual creates a conservation easement, the effect of this step is to reduce the market value of the land since prospective purchasers who would otherwise acquire it for development are effectively barred from the market.

In Step Three, the land trust sells the land (which is now encumbered by the easement) to a purchaser who is willing to limit his or her use of the land to activities that are permitted under the easement. Because this friendly or sympathetic buyer is motivated at least partially by the conservation considerations of the property, he or she is generally willing to underwrite all or part of the land trust's loss on the purchase and sale in either of two ways.

Alternative A — In some instances, this donor/buyer makes a cash contribution to the land trust sufficient to make it whole (i.e., an amount equal to the difference between the price originally paid by the land trust for the property and the lesser amount paid for the property by the donor/buyer).

Alternative B — In other instances, the donor/buyer simply pays the land trust a price for the land equal to what the land would be worth in the absence of the easement (typically the same amount the land trust paid).

In either case, whether the donor/buyer proceeds under Alternative A or Alternative B above, the result is the same. The total outlay of the donor/buyer is equal to the full, unencumbered value of the property, and the excess over the actual value (reflecting the restrictions imposed by the conservation easement) is deductible for income tax purposes.

#### Example

Using a simple example, let's assume TNC acquires a tract of forest land for \$1,000,000. The land can be developed into a series of 5-acre homesites, and the \$1,000,000 price reflects this factor. TNC conveys to a local governmental agency a conservation easement precluding such development of the land and any other activity (e.g., logging, strip mining, operation of a business, etc.) that would be deleterious to the pristine forest nature of the property. This means that any future purchaser is limited in his or her ability to realize the full economic value of the land. Accordingly, the land cannot be sold in the open market for more than \$700,000. The values are confirmed by reliable professional appraisals.

TNC locates a buyer, D, who will buy the property subject to the easement for \$700,000, and this sale is consummated. At the closing or soon thereafter, D voluntarily contributes \$300,000 in cash to TNC, so that it breaks even on the transaction. This is the approach used in Alternative A above. Alternatively, D may buy the property from TNC for \$1,000,000, the same amount TNC paid for it. Since D is paying \$1,000,000 for an asset that is worth only \$700,000, D has conferred a \$300,000 benefit on TNC. This is Alternative B.

Because TNC is a qualified charity and the benefit in question (either the \$300,000 cash contribution in Alternative A or the \$300,000 cash benefit in Alternative B) was conferred with the intention of supporting the charitable mission of TNC, D will be entitled to a charitable contribution deduction in the amount of \$300,000 for income tax purposes under either approach.

### Availability of Deductions

You indicated that some question has been raised as to the proper deductions allowable under one or both of these alternatives, and I believe I can say with certainty that the buyer (D in our example) is clearly entitled to the deductions described, subject to the normal conditions (e.g., a qualified donee, substantiation by means of a timely receipt, qualified appraisals, percentage limitations based upon the donor's adjusted gross income, etc.). Indeed, this seems only appropriate, since in each case D is out of pocket (and the land trust is enriched) by this amount.

In the case of the cash contribution in Alternative A, there would seem to be little room for argument assuming the values are correct. In the case of the purchase of property at a price in excess of value (Alternative B), the economic result is the same, and the tax result follows. The Regulations provide for this result in §1.170A-1(h), where a taxpayer who purchases goods or services from a charitable organization, but intentionally pays an amount in excess of the fair market value of the goods or services is entitled to a charitable contribution deduction. This is the case in the everyday situation where a donor buys a charitable gift annuity from a charity, where the amount payable for the annuity is set at a level which exceeds the value of the annuity purchased; the excess is deductible as a charitable contribution. The IRS has recognized this principle in the Regulations [§1.170A-1(d)(1)] and in Revenue Ruling 70-15, 1970-1 CB 20. Moreover, the Supreme Court has upheld this principle in United States v. American Bar Endowment, 477 US 105 (1986), where the Court stated as follows:

"The sine qua non of a charitable contribution is a transfer of money or property without adequate consideration. The taxpayer, therefore, must at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return."

Of course, the critical question is one of respective values — the amount paid by the donor/buyer versus the value of the property received. As with any charitable contribution situation involving property, these values must be determined by appraisals, and are subject to question by the Internal Revenue Service on audit of the taxpayer making the contribution. The donee organization is not involved in the valuation process, and the determination of value (including defense of any attack by IRS) is entirely the donor's obligation.

\* \* \*

I hope this discussion is helpful. Please let me know if there are any additional questions or if I should elaborate on any of the points discussed above,

Sincerely,

Jerry J. McCoy

**JERRY J. McCOY**

Office:

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(202) 466-6941 [fax (202) 466-6942]  
mccoylelaw@aol.com

Professional Associations

Private Practice, Washington, D.C. (Since 1994)

Diversified tax practice with heavy specialization in tax-exempt organizations, charitable tax planning and estate planning. Clients include colleges and universities, national and international charitable organizations, private foundations and related organizations, both publicly- and closely-held businesses, and private individuals.

Reid & Priest  
Washington, D.C. (1992-94)

Silverstein and Mullens  
Washington, D.C. (1968-1992)

Charitable Gift Planning News, a monthly newsletter published by Little, Brown & Co., Boston, Mass. until June, 1990, now published by the co-editors (Co-Founder and Co-Editor, 1983 to date)

Co-founder and co-author of monthly newsletter on tax and other considerations affecting charitable giving; circulation includes development officers for educational institutions and other charitable organizations, as well as attorneys, accountants, financial planners, life underwriters, and other donee advisors.

Family Foundation Advisor, a monthly newsletter published by Aspen Law & Business (A Wolters Kluwer Company), New York beginning February, 2002

Co-founder and co-editor of monthly newsletter for advisors and managers of family foundations, designed to complement the Family Foundation Handbook (listed below).

Professional Organizations

American Bar Association, Section of Real Property, Probate and Trust Law (Washington Coordinator for the Probate and Trust Division; Group Chairman for Committees on Charitable Planning and Exempt Organizations)

American Bar Association, Section of Taxation (Co-Chairman, Subcommittee on Community Foundations of Exempt Organizations Committee; former Chairman of Legislative Recommendations Committee)

Fellow of The American College of Trust and Estate Counsel (Chairman, Charitable Planning and Exempt Organizations Committee; 1990-91 Editor of Probate Notes)

Fellow of The American College of Tax Counsel

Member, American Law Institute

Adjunct Faculty, Georgetown University Law Center (coinstructor for charitable tax planning course in the Master of Laws in Taxation Program, 1996-date)

Adjunct Faculty, University of Miami Law School (coinstructor for charitable tax planning course in the Master of Laws in Estate Planning Program, 1983-date)

Founding Faculty, American Institute of Philanthropic Studies, California State University, Long Beach

Named in Who's Who in America and Who's Who in American Law (Marquis), and The Best Lawyers in America (1999-2000 ed., published by Woodward/White)

#### Other Memberships and Positions

Founding Member, Board of Directors, International Institute of Association and Foundation Lawyers

Founding Member, Board of Directors, International Planned Giving Foundation

Member, Board of Directors, National Committee on Planned Giving (1992-1994)

Assistant Treasurer, National Park Foundation (1972-1993)

Treasurer and Co-Counsel, Commission on Private Philanthropy and Public Needs [The Filer Commission] (1973-1976)

Member, Advisory Committee, Philip E. Heckerling Institute on Estate Planning, University of Miami, 1978 to date

Advisory Board, The Exempt Organization Tax Review (a Tax Analysts publication)

Board of Advisers, The Journal of Taxation of Exempt Organizations (a Warren, Gorham & Lamont publication)

### Publications and Lectures

Co-Author (with Kathryn W. Miree), Family Foundation Handbook, Published January 2001 by Aspen Law & Business (A Wolters Kluwer Company), New York.

Author, United States chapter in International Charitable Giving: Laws and Taxation, (Carole Shelbourn George, ed.), Published 1994 by Graham & Trotman/Martinus Nijhoff (Kluwer Academic Publishers Group), London/Dordrecht.

Author of articles on tax, estate planning, and charitable subjects in various professional publications (in addition to the institutes listed above), including *Trusts & Estates*, *The Journal of Taxation of Exempt Organizations*, *Tax Law Review*, *TAXES - The Tax Magazine*, *Taxation for Accountants*, *Taxation for Lawyers*, *The Practical Tax Lawyer*, and numerous publications of *Tax Management, Inc.* (a division of the Bureau of National Affairs, Inc.)

Speaker at national, regional and local meetings on tax and estate planning subjects, including the following:

Philip E. Heckerling Institute on Estate Planning, (University of Miami)  
New York University Institute on Taxation  
Southern Federal Tax Institute  
American Bar Association (Annual Meetings)  
Tulane Tax Institute  
Midwest Tax & Business Planning Institute  
Duke Estate Planning Conference  
UCLA/CEB Estate Planning Institute  
Georgetown Law Center/D.C. Bar Institutes  
Notre Dame Estate Planning Institute  
National Conference on Planned Giving  
American College of Trust and Estate Counsel (Annual Meetings)  
International Association for Financial Planning  
(National Conventions)  
ALI/ABA National Institutes  
Various State Bar Meetings, Local Planned Giving Councils, Estate Planning Councils and  
Community Foundations Nationwide

### Education

LL.M. (in Taxation), New York University School of Law, New York, N.Y. (1967)

LL.B., Duke University School of Law, Durham, N.C. (1966)

B.S. in Business Administration, West Virginia University, Morgantown, W.Va. (1963)



January 29, 1997

VIA OVERNIGHT MAIL

**Catherine W. White**  
Stephoe & Johnson  
1330 Connecticut Avenue, NW  
Washington, DC 20036

Re: Davis Mountains Ranch Conservation Project, TX

Dear **Catherine**:

As we discussed last week, The Nature Conservancy has a contract to purchase 32,528.70 acres of the **White** Ranch in the Davis Mountains area of West Texas. The purchase price is \$330 an acre for a total of \$10,734,471. I have enclosed a copy of an appraisal commissioned by us which shows the fair market value at \$11,400,000. The remaining 6,500 acres of the ranch will be retained by **White**, who intends to donate a conservation easement over the 6,500 acres to the Conservancy.

The project will be known as the Davis Mountains Ranch. To finance most of the project, we intend to sell six ranch tracts ranging from 2,548 acres to 4,265 acres in size. Prices will vary from \$1,683,333.00 to \$1,883,334.00. Each tract will be sold subject to a conservation easement retained by The Nature Conservancy which will prohibit subdivision, limit construction to one ranch complex, and allow grazing subject only to a grazing management plan worked out with the Conservancy. Each purchaser will also have limited use rights in a 4,075 acre "common area." This common area will be owned by a nonprofit Texas corporation to be set up by the Conservancy - the Brown Mountain Landowners Association. Each tract owner will be able to use this common area for hiking, hunting, horseback riding, etc. The members of the Brown Mountain Landowners Association will consist of the Conservancy and the owner of each tract. The whole project will be subject to a declaration of covenants, conditions and restrictions, such as you might have in a residential subdivision, that will make the rights and duties of the tract owners in the common area appurtenant to their tract. The remaining acreage (9,475 acres) will be retained by the Conservancy as a preserve. It will include the most spectacular portions of the property in terms of scenery and biodiversity. I have enclosed a project brochure which contains maps which will illustrate all of this more clearly.

101 Conner Drive  
Suite 302  
Chapel Hill, North Carolina  
27514

P.O. Box 2267  
Chapel Hill, North Carolina  
27515-2267

919 967-5493  
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International  
Headquarters  
Arlington, Virginia  
703 841-5300

To meet our conservation goals means the Conservancy must retain a substantial portion of the economic value of the property. The Texas Chapter does not have the assets to cover the value retained, and thus we are requiring the various tract buyers to pay a premium to cover our costs, and provide for startup expenses and a stewardship endowment. The Board of Governors has made it clear that the Texas Chapter must have \$8 million in income from the sale of tracts closed simultaneously with the purchase of this property. We could close as early as February 26, but closing may be postponed because the [REDACTED] are still in the process of securing survey patents from the State of Texas for portions of the property.

What we need is a memorandum from your firm to The Nature Conservancy that addresses the likely outcome of several tax-related matters which will arise in connection with lining up purchasers for this property. We are telling each potential purchaser that they must secure their own tax advice. However, it would be helpful to have a memorandum on these issues which we could give to potential purchasers who could then share them with their accountants or lawyers. The memo, of course, should contain a message in bold print that it is not intended as advice for the purchasers and that purchasers should seek their own counsel. I believe such a memo would go a long way in focusing the purchasers on the relevant issues. The memo would essentially be an update of your January 31, 1992 opinion to [REDACTED] and cover the following issues:

1. Is a purchaser entitled to a charitable deduction for a "premium" paid for real property?
2. How should such a transaction be constructed? Alternative One would be to use one document which recites a purchase price which includes the premium amount and then provides that both parties recognize that the buyer is paying a premium for which the purchaser will claim a deduction. In this alternative, should the purchaser obtain an appraisal before closing, or can this be done post-closing? If it is done before closing, should the contract recite the "fair market amount" and the "premium" amount? Alternative Two would be to have the purchaser obtain an appraisal, and then enter into a contract for the purchase of the property for the fair market value. At the same time the purchaser would give the Conservancy a pledge for the premium. Would the IRS compress this into one transaction anyway? Are charitable pledges enforceable in Texas? Are there other alternatives?
3. Two of the potential purchasers have indicated a strong desire to use appreciated stock to pay the premium portion of the price. In Alternative One or Two above how will the IRS treat this use of stock? If we make it clear in the contract that the stock represents the premium, will the IRS respect such a designation, will they allocate the stock between the fair market portion and the premium portion, or will they redesignate it to the fair market value portion of the purchase price? Would having the stock given through a separate pledge help matters?

4. You should also know that two of the potential purchasers have close ties to the Texas Chapter. One is a Chapter Trustee and the other serves on a real estate committee.

Once you have had a chance to review these matters, please call me to discuss your initial reactions and your fees. In addition to the memorandum, I would also foresee you talking with purchasers' attorneys on tax issues. Of course, I hope you can use your West Texas rates.

Very truly yours,



David Bland  
Regional Attorney

DB/dsf

cc: James King, Director of Protection, Texas (w/out enc.)  
Mike Dennis (w/out enc.)  
Phil Tabas, Eastern Regional Attorney (w/out enc.)  
Patrick Ramos, Western Regional Attorney (w/out enc.)  
Mike Andrews, Southeast Regional Director (w/out enc.)

Enclosures

# STEPTOE & JOHNSON LLP

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March 10, 1997

**VIA FAX AND EXPRESS MAIL**

David Bland, Esquire  
Regional Attorney  
The Nature Conservancy  
101 Conner Drive  
Suite 302  
Chapel Hill, NC 27514

Re: Davis Mountains Ranch Conservation Project, TX

Dear David:

As you requested, we have considered the tax issues relating to the Davis Mountains Ranch Conservation Project. We understand that The Nature Conservancy ("TNC") has a contract to purchase 32,528.70 acres of the  Ranch in the Davis Mountains area of West Texas for a conservation project. We further understand that, to help finance the conservation project, TNC plans to sell six ranch tracts subject to a conservation easement. TNC intends to charge a premium for these tracts in order to cover its costs and provide for start-up expenses and a stewardship endowment. You have asked us to determine whether a potential purchaser will be entitled to a charitable deduction for the premium payment. Further, you have asked us to consider the tax consequences if a potential purchaser uses appreciated stock in lieu of cash for some portion of the transaction and, if a charitable deduction will be permitted under either form of payment, to provide advice on how the proposed alternative forms of the transaction should be structured.

David Bland, Esquire  
March 10, 1997  
Page 2

### Charitable Deduction for Premium Paid

A purchaser who pays a premium to purchase a parcel of the Davis Mountains Ranch property from TNC should be entitled to a charitable deduction under Section 170(a) of the Internal Revenue Code of 1986, as amended (the "Code") for the amount paid in excess of the fair market value of the land. Although we have not located any cases or rulings dealing directly with a premium paid by a taxpayer to purchase land from a charity, the Internal Revenue Service (the "Service") recognizes the deductibility of a premium payment in other contexts. For instance, in the annuity context, the Service specifically allows a charitable deduction for amounts paid to charities for annuity contracts in excess of their fair market value. See Treas. Reg. § 1.170A-1(d); Rev. Rul. 70-15, 1970-1 C.B. 20. Similarly, where a taxpayer purchases a ticket to a charitable event for an amount in excess of fair market value, the Service allows a charitable deduction for the excess amount. Rev. Rul. 64-246, 1967-2 C.B. 104 (price of ticket to charity ball deductible to extent it exceeds market value of admission).

Furthermore, the United States Supreme Court has specifically recognized that a payment to a charity can have the dual character of a purchase and a contribution. In United States v. American Bar Endowment, 477 U.S. 105 (1986), the Supreme Court denied a charitable deduction for a portion of the payments made by individuals to the American Bar Endowment for insurance because the amount paid did not exceed the fair market value of the insurance received. In doing so, however, the Court recognized:

Where the size of the payment is clearly out of proportion to the benefit received, it would not serve the purposes of § 170 to deny a deduction altogether. A taxpayer may therefore claim a deduction for the difference between a payment to a charitable organization and the market value of the benefit received in return, on the theory

David Bland, Esquire

March 10, 1997

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that the payment has the "dual character" of a purchase and a contribution.

Id. at 117.

The Service and the courts have adopted a two-part test for determining when a part of a "dual payment" is deductible. Rev. Rul. 64-246, 1967-2 C.B. 104; see also, American Bar Endowment, 477 U.S. at 117. First, the payment is deductible only if and to the extent it exceeds the market value of the benefit received. Second, the amount paid in excess of fair market value must be made with the intention of making of gift.

Thus, since the Davis Mountains Ranch property is being sold at a price in excess of fair market value, the premium payment should be deductible under Section 170(a) of the Code so long as the transaction makes clear that the purchaser intends to make a gift to TNC of the premium amount.

#### Use of Appreciated Stock

We understand that some purchasers may want to use appreciated stock to pay a portion of the purchase price for a parcel of the Davis Mountains Ranch property. The use of appreciated stock will have different tax results depending on whether the appreciated stock is attributed to the purchase element or the gift element of the transaction.

If the appreciated stock is attributed to the purchase element, the purchaser will realize gain on the transaction subject to tax. Section 1001(a) of the Code provides gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis of the property. For this purpose, the amount realized is the amount of cash plus the fair market value of the property received. I.R.C. § 1001(b). Thus, under Section 1001, a purchaser who uses appreciated stock to purchase a parcel of the Davis Mountains Ranch property would recognize gain equal to the excess of the fair market value of the parcel over the purchaser's adjusted basis in the stock.

David Bland, Esquire  
March 10, 1997  
Page 4

On the other hand, if the appreciated stock is used to make a gift to TNC for the premium amount, the purchaser will be entitled to an income tax charitable deduction for the full fair market value of the stock contributed, subject to certain percentage limitations. See I.R.C. § 170(e)(1); see also § 170(b)(1). Thus, using the appreciated stock to make a gift to TNC rather than to purchase the land will result in substantially more favorable tax treatment.

#### Structure of Transaction

As you suggested in your letter, there are two alternatives for structuring the sale of the Davis Mountains Ranch tracts. The first is to combine the purchase of the land with the charitable contribution to TNC in a single transaction. The second is to separate the purchase and the gift into two distinct transactions.

If the total purchase price will be paid in cash, we see no reason why the transaction cannot be structured as a single transaction so long as the contract of sale clearly states the fair market value of the land and indicates that the amount paid in excess of the fair market value is intended to be a gift to TNC. To the extent that potential purchasers want to use appreciated stock to pay for the premium portion of the purchase price, however, we recommend that the transaction be separated into two distinct transactions, each with its own separate documentation: (1) a purchase of the property in cash for the fair market value and (2) a gift of appreciated stock in the amount of the premium. This should insure that the appreciated stock is treated as the gift element and the cash is treated as the purchase element, thereby avoiding the recognition of gain discussed above.

We understand that some purchasers may want to give TNC a pledge for the premium amount at the time of the closing. In order to protect TNC's interests, we suggest that TNC require that at least half of the premium amount be paid at the time of closing. As we discussed, we are uncertain whether a charitable pledge by a Texas resident for the unpaid premium amount would be enforceable under Texas law. Therefore, we recommend that in

David Bland, Esquire  
March 10, 1997  
Page 5

such circumstances TNC take a note from the purchaser for the unpaid premium amount. However, you should confirm with your Texas counsel that such a note would be enforceable in Texas and obtain advice on what the precise terms of the note should be.

Regardless of how the transaction is structured, a qualified appraisal should be obtained within 60 days prior to closing to determine the fair market value of the property and thus the amount of the premium. See Treas. Reg. § 1.170A-13(c)(3). The appraisal should state the fair market value of the land, taking into account the conservation easement retained by TNC.<sup>14</sup> It is not necessary for the appraisal to state the value of the premium payment.

Finally, we understand that at least two of the potential purchasers have close ties with the Texas Chapter of TNC. As a result, any scrutiny by the Service of the transactions with these purchasers is likely to be particularly thorough. Therefore, you will want to make sure that all the transactions are structured in compliance with the regulations under Section 170 of the Code and in accordance with the highest standards so that there is no question that they were conducted at arm's-length.

---

<sup>14</sup> The appraisal should include the following: (1) a description of the land being sold; (2) the date of the appraisal and the closing; (3) the terms of the agreement, including a description of the conservation easement retained by TNC; (4) the name, address and federal identification number of the qualified appraiser; (5) the qualifications of the qualified appraisal; (6) a statement that the appraisal was prepared for income tax purposes; (7) the appraised fair market value of the land; (8) the method of valuation used; and (9) the specific basis for the valuation, such as specific comparable sales transactions. Treas. Reg. § 1.170A-13(c)(3)(ii).

David Bland, Esquire

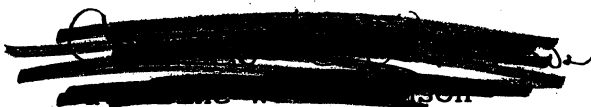
March 10, 1997

Page 6

If you have any questions or would like to discuss these issues further, please give me a call.

Best regards.

Sincerely,

A large, thick black horizontal bar redacting the signature. The word "son" is visible at the bottom right of the redacted area.

LTR-RUL, UIL No. 170.00-00 Charitable, etc. contributions and gifts; UIL No. 511.00-00 Tax on unrelated business income of charitable, etc., organizations (Taxable v. not taxable), Letter Ruling 200213021, (Dec. 14, 2001)  
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Letter Ruling 200213021, December 14, 2001  
 CCH IRS Letter Rulings Report No. 1309, 04-03-02  
 IRS REF: Symbol: CC:ITA:2-PLR-135425-01

*Provided to*  
~~\_\_\_\_\_~~

#### Uniform Issue List Information:

UIL No. 0170.00-00

Charitable, etc. contributions and gifts

UIL No. 0511.00-00

Tax on unrelated business income of charitable, etc., organizations (Taxable v. not taxable)

#### [Code Sec. 170]

This responds to your letter dated April 30, 2001, requesting a ruling on the proper federal income tax treatment of a proposed fund-raising activity involving the sale of the right to use niches and cenotaphs to members of the Roman Catholic community at a price which significantly exceeds the fair market value.

#### REQUESTED RULINGS:

1) Taxpayer's proposal of offering columbarium niches and cenotaphs for greater than fair market value falls within the guidelines for qualifying as a charitable contribution with a partial consideration component under §170 of the Internal Revenue Code.

2) No part of the payments received by Taxpayer with respect to rights to use the columbarium under the proposed Donor Agreement will be unrelated business income under §511.

#### APPLICABLE FACTS:

Taxpayer is a parish of the Roman Catholic Church with principal offices located at X in state Y. Taxpayer is a tax-exempt entity under section 501(c)(3) of the Internal Revenue Code and is classified as a church and as an organization which is not a private foundation under §§170(b)(1)(A)(i) and 509(a)(1). The functions of taxpayer include ownership and operation of church property within the parish.

Taxpayer represents that conducting funeral masses, burying the dead and performing other sacraments for the dying and the bereaved are basic religious functions of the Roman Catholic Church directly associated with its fundamental doctrines. As part of its ministry, the Church has, for many centuries, provided consecrated burial grounds and crypts, more recently, columbaria for the interment of deceased loved ones.

Taxpayer is currently constructing a columbarium on the church's property which will include niches for the interment of cremated remains and cenotaphs for remembrances of loved ones buried elsewhere. Taxpayer proposes to initiate a fund-raising program under which members of the Catholic community may purchase the right to use the niches and cenotaphs at a price which significantly exceeds the fair market value (FMV). It is proposed that a buyer/donor wishing to use a niche or cenotaph will execute a Donor's Agreement. The Donor's Agreement does not obligate Taxpayer to furnish other goods or services customarily offered by funeral homes, nor does Taxpayer intend to do so. The proposed payments, pre-development and post-development, and the estimated FMV for these donations are as follows:

Item	Pre-Development	Post-Development	FMV
Hillside Companion Niche	\$a	\$b	\$d
Cenotaph	\$c	\$c	\$e

#### LAW AND ANALYSIS

##### REQUESTED RULING NO. 1:

Section 170(a)(1) permits a deduction for a charitable contribution, as defined in §170(c). Section 170(c) defines a charitable contribution as a contribution or gift to or for the use of certain qualifying organizations.

A contribution or gift, for the purposes of §170 is a voluntary transfer of money or property made by the transferor

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without receipt or expectation of a financial benefit commensurate with the money or property transferred. See Section 1.170A-1(c)(5) of the Income Tax Regulations.

Rev. Rul. 67-246, 1967-2 C.B. 104, states that, to be deductible as a charitable contribution for federal income tax purposes under section 170, a payment to or for the use of a qualified charitable organization must be a gift. To be a gift for such purposes, there must be, among other requirements, a payment of money or transfer of property without adequate consideration. The Supreme Court has stated that the "sine qua non of a charitable contribution is a transfer of money or property without adequate consideration." United States v. American Bar Endowment, 477 U.S. 105, 118 (1986) [86-1 USTC ¶9482].

Rev. Rul. 67-246 establishes a two-part test for determining when part of a dual character payment is deductible. First, the payment is deductible only if and to the extent it exceeds the market value of the benefit received. Second, the excess payment must be "made with the intention of making a gift." Rev. Rul. 67-246 further states generally, where a transaction involving a payment is in the form of a purchase of an item of value, the presumption arises that the gift was not made for charitable contribution purposes, the presumption being that the payment in such a case is the purchase price. If a charitable contribution deduction is claimed with respect to the payment, the burden is on the taxpayer to establish that the amount paid is not the purchase price of the privileges or benefits and that part of the payment, in fact, does qualify as a gift. Thus, in showing that a gift has been made, it is essential for the taxpayer to establish that the portion of the payment that is claimed as a gift represents the excess of the total amount paid over the FMV of any substantial privileges or benefits received in return.

Accordingly, Rev. Rul. 67-246 states that if payments solicited for a charitable fund-raising activity are designed to be partly a gift and partly the purchase price of certain privileges or benefits, the organization conducting the activity should employ procedures that make clear not only that a gift is being solicited in connection with the activity, but also the amount of the gift being solicited. To do this, the amount of property attributable to the purchase of privileges or benefits and the amount solicited as a gift should be determined in advance of solicitation. In making such a determination, the FMV of any substantial privileges or benefits attributable to the purchase must be taken into account. After making such a determination the charitable organization should notify its donors of the amounts allocable to each component of the payment. See Rev. Rul. 67-246, 1967-2 C.B. at 105-6; Rev. Proc. 90-12, 1990-1 C.B. 471.

In the instant case, Taxpayer proposes a charitable fund-raising activity designed to be partly a gift and partly the purchase price of certain privileges or benefits. Specifically, Taxpayer plans to offer the right to use the columbarium's niches and cenotaphs on its property to members of the Catholic community at a price which significantly exceeds FMV. Taxpayer is employing procedures that make clear not only that a gift is being solicited in connection with the activity, but also the amount of the gift being solicited. Taxpayer informs potential buyer/donors of the FMV of the niches and cenotaphs along with pre- and post-development prices. Taxpayer notifies buyers/donors of the amounts allocable to each component of the payment by way of a Donor's Agreement which states that the FMV for a niche is \$d and \$e for a cenotaph.

Based on the facts presented, the proposed transactions clearly take the form of a purchase and contribution. Taxpayer has satisfied the two-part test in Rev. Rul. 67-246. Thus, Taxpayer's proposal of offering columbarium niches and cenotaphs for greater than FMV falls within the guidelines for qualifying as a charitable contribution with a partial consideration component under §170.

## REQUESTED RULING NO. 2:

Section 501(c)(3) provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable and religious purposes.

Section 511 imposes a tax on the "unrelated business taxable income" of organizations otherwise exempt from federal income tax under §501(c)(3).

Section 512(a)(1) defines "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business as defined in §513 regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business.

Section 513(a) defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting

LTR-RUL, UIL No. 170.00-00 Charitable, etc. contributions and gifts; UIL No. 511.00-00 Tax on unrelated business income of charitable, etc., organizations (Taxable v. not taxable), Letter Ruling 200213021, (Dec. 14, 2001)  
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the basis for its exemption under §501.

Section 513(c) provides that the term "trade or business" includes any activity carried on for the production of income from the sale of goods or the performance of services.

Section 1.511-2(a)(3)(iii) provides that, beginning in 1969, but with certain transitional rules covering tax years beginning before January 1, 1976, churches are subject to the tax on unrelated business taxable income under §511.

Section 1.513-1(a) provides that, unless one of the specific exceptions of §512 or 513 applies, the gross income of an exempt organization subject to §511 is includible as unrelated business income if: (1) the income is from a "trade or business," (2) such trade or business is "regularly carried on" by the organization, and (3) the conduct of such trade or business is not substantially related (aside from the need for, or the production or use of, the funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) provides that, for purposes of §513, the term "trade or business" has the same meaning that it has in §162 and, generally, includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c)(1) provides that, in determining whether a trade or business from which a particular amount of gross income derives is "regularly carried on" within the meaning of §512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(d)(2) provides that for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

In Senate Report Number 91-552, 91st Congress, 1st Session 70 (1960). 1969-3 C.B. 469, on the Tax Reform Act of 1969, Public Law 91-172, the Committee on Finance stated that, in the case of churches, the term unrelated business income will not include the operation and maintenance of cemeteries as long as they are carried on in connection with the church.

Rev. Rul. 79-359, 1979-2 C.B. 226, holds that an organization providing traditional religious burial services qualifies for recognition of exemption under §501(c)(3). It states that provision of burial services to members of a religion in compliance with the requirements of the religion's laws perpetuates traditional religious customs and obligations and contributes to the advancement of religion.

In the instant case, the proposed sales of niches and cenotaphs will be a trade or business carried on within the meaning of §§ 1.513-1(b) and (c). Thus, the issue here depends on whether such activity is substantially related to the parish's exempt purposes as required by §513(a). The parish church's columbarium's niches and cenotaphs will be used for decedents with respect to whom the Roman Catholic Church has conducted or expects to conduct a funeral ceremony (or ceremony in which Roman Catholic ordained clergy or those under vows preside or participate). Based on the legislative history cited above, a church's operation and maintenance of a cemetery or this columbarium with niches and cenotaphs for decedents of the church's religious denomination would not be an unrelated trade or business. As in Rev. Rul. 79-359, providing traditional burial services that directly support and maintain basic tenets and beliefs of a religion regarding the burial of its members furthers the religious and charitable purpose of advancement of religion and, thus, is related to furtherance of exempt purposes under §501(c)(3).

Accordingly, based on the facts presented we rule as follows. Taxpayer's sales of the rights to use the columbarium's niches and cenotaphs, in connection with anticipated funeral ceremonies to be performed there or elsewhere by the Roman Catholic Church with respect to the decedents, will be substantially related (aside from the production of income) to the parish's exempt religious and charitable purposes under §501(c)(3) and, thus, will not be an unrelated trade or business under §513(a), and will not result in unrelated business taxable income under §511.

#### RULINGS:

Based solely on the facts and representations submitted, we conclude and rule as follows:

- (1) Taxpayer's proposal of offering columbarium niches and cenotaphs for greater than FMV falls within the guidelines

**Faison  
Stone**

## FAX TRANSMITTAL COVER SHEET

DATE: 1-30-97

PLEASE DELIVER THE FOLLOWING PAGE(S) TO:

NAME: ~~XXXXXXXXXX~~  
 FIRM: NATURE CONSERVANCY FAX NO: (210) 228-9805  
 FROM: WILL WYNN  
 FAX NO.: (512) 477-3940

Got your phone message today. Things look encouraging.  
 Several issues:

- ① really need your help to ensure that Horn Blum and Steptoe & Johnson do everything they can to make Mel comfortable on the NET cost of this deal after-tax.
- ② ~~Tom Blum~~ sounded very busy but may be able to get us a letter prior to closing. He would need to see the deed restrictions ASAP. Unfortunately his initial reaction to the value decrease wasn't "encouraging as hoped."
- ③ we need to focus on the deed restriction language
- ④ \*330/acre vs. \*350/acre or today's Fair Market Value

Mel's interest is clearly in both tracts combined on a "Net Cost" basis. I'm very encouraged.

[ ] HARD COPY TO FOLLOW BY MAIL [X] HARD COPY NOT TO FOLLOW  
 [ ] HARD COPY TO FOLLOW BY FEDERAL EXPRESS

A TOTAL OF 3 PAGES (INCLUDING THE COVER SHEET) WERE  
 TRANSMITTED TO YOU. IF YOU DO NOT RECEIVE ALL OF THE PAGES,  
 PLEASE CALL BACK AS SOON AS POSSIBLE TO (512) 477-3434.

MEMORANDUM

**Faison  
Stone**

TO: [REDACTED]

VIA FAX & US MAIL

CC: [REDACTED]

FROM: WILEY WAIN [REDACTED]

DATE: JANUARY 29, 1997

RE: DAVIS MOUNTAINS RANCH

Attached please find two revised after tax net cost analyses. These assume that 50% of the stock gift is appreciated value. I will visit with the appraiser and get his input as to fair market value subsequent to the deed restrictions. Obviously, the fair market value has a substantial impact on this net cost analysis.

In a related matter, I spoke with [REDACTED] The Nature Conservancy's (in-house) attorney in Chappel Hill, NC - (919) 967-1575 x 116. He is very comfortable with the above-market donation/tax benefit issue. He has asked their Washington, DC-based tax counsel to write an opinion on the following:

1. The tax deduction on above-fair market value consideration on this proposed transaction, and
2. The (avoidance of) capital gains tax on an appreciated stock gift in conjunction with this proposed transaction.

This opinion should be received in the next ten days.

They are also developing recommendations on the wording and structure of the documents to further the acceptance of this proposed transaction by the IRS.

We are welcome to contact that law firm if needed in the meantime. The contact is [REDACTED] with the firm of Steptoe and Johnson [REDACTED]

bcc: [REDACTED]

## MEMORANDUM

**Faison  
Stone**

TO: [REDACTED]  
CC: [REDACTED]  
FROM: [REDACTED]  
DATE: JANUARY 29, 1997  
RE: DAVIS MOUNTAINS RANCH

VIA FAX &amp; US MAIL

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We are welcome to contact that law firm if needed in the meantime. The contact is [REDACTED] with the firm of Steptoe and Johnson, [REDACTED]

bcc: [REDACTED]

**DAVIS MOUNTAINS RANCH**  
**Net Cost Analysis**

01/28/97

Adjusted acreages			
	acres	price	per acre
Salcido Tract	3,350	\$1,883,334	\$562
Limpia Tract	3,220	\$1,883,334	\$585
total	6,570	\$3,766,668	\$573

**COMBINED TRACTS**

Donation      \$1,149,750      Cash at closing (new appraised value of \$175/acre).  
                  2,616,918      Separate stock pledge. Tax reduction (@39%) of      \$1,020,598  
                  \$3,766,668

\$1,149,750      Cash at closing.  
 2,250,549      Stock value after (28% capital gains) tax on 50%.  
 \$3,400,299

(1,020,598)      Tax reduction.

\$2,379,701      **\$362 per acre AFTER TAX NET COST**

**STEPTOE & JOHNSON LLP**

ATTORNEYS AT LAW

PHOENIX, ARIZONA  
FACSIMILE: 602.257.5299  
VERIFICATION: 602.257.5287

1330 CONNECTICUT AVENUE, NW  
WASHINGTON, D.C. 20036-1795  
MAIN NUMBER: 202.429.3000  
www.steptoelaw.com

LOS ANGELES, CALIFORNIA  
FACSIMILE 213.439.9599  
VERIFICATION: 213.439.9400

**FACSIMILE: 202.429.3902**  
**VERIFICATION: 202.429.8152**

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**DELIVER TO:**

NAME: **James P. Dine, Esq.** TELECOPY PHONE NUMBER: **[REDACTED]**  
**Legal Counsel, Northeast Division**  
COMPANY: **The Nature Conservancy** VERIFICATION NUMBER: **[REDACTED]**  
TOTAL PAGES & COVER SHEET: **14** DATE TRANSMITTED: **6/7/01**  
S&J OPERATOR'S NAME: **[REDACTED]** TELEPHONE NUMBER: **[REDACTED]**  
CLIENT/CASE NUMBER: **[REDACTED]**

**FROM:**NAME: **C. [REDACTED] direct dial [REDACTED]**

REQUEST MADE ON	DATE: <b>6/7/01</b>	TIME: <b>9:17 AM</b>
COMPLETION REQUIRED BY	DATE: <b>6/7/01</b>	TIME: <b>ASAP</b>

**SPECIAL INSTRUCTIONS:** **[REDACTED]** Attached documents for your review for our 12:30 conference call.  
Regards **[REDACTED]**

**IMPORTANT:** This facsimile is intended only for the use of the individual or entity to which it is addressed. It may contain information that is privileged, confidential, or otherwise protected from disclosure under applicable law. If the reader of this transmission is not the intended recipient or the employee or agent responsible for delivering the transmission to the intended recipient, you are hereby notified that any dissemination, distribution, copying or use of this transmission or its contents is strictly prohibited. If you have received this transmission in error, please notify us by telephoning and return the original transmission to us at the above address.

**STEPTOE & JOHNSON LLP**

ATTORNEYS AT LAW

1330 Connecticut Avenue, NW  
Washington, DC 20036-1795

Telephone 202.429.3000  
Facsimile 202.429.3902  
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Deborah W. Wilkinson CPA  
202.429.6262  
dwilkinson@steptoelaw.com

**MEMORANDUM**

*via Facsimile*

TO: [REDACTED]  
[REDACTED]

FROM: [REDACTED]  
[REDACTED]

RE: Use of LLC in Connection with Murray/The Nature Conservancy  
Eastern Shore Transaction

As you requested, we have researched issues that may arise if The Nature Conservancy ("TNC") uses a limited liability company ("LLC") in connection with the sale of land to [REDACTED] ("Murray"). As we understand the proposed transaction, TNC and [REDACTED] would form an LLC of which they would be the only members. [REDACTED] would contribute to the LLC an amount of cash roughly equal to the fair market value of the subject land and would receive a majority interest in the LLC. TNC would invest a small amount of cash in the LLC in exchange for a proportionately small interest in the LLC. Subsequently, the LLC would purchase the parcel of land from TNC at the appraised fair market value price.

Despite their unequal interests in the LLC, TNC and [REDACTED] would have equal control rights with respect to the LLC. In other words, TNC and [REDACTED] each would have the right to consent to significant transactions, including the development or sale of the land or the

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placing of restrictions on the land. The LLC agreement would not contain an explicit requirement that a conservation easement be placed on the property within a certain period of time. It is contemplated, however, that at some point in the future both parties would agree on the form of, and consent to the granting of, a conservation easement to TNC, although the eventual granting of an easement is not a foregone conclusion.

It is intended that the granting of a conservation easement would result in a charitable deduction that would flow through the LLC to the members of the LLC. Because [REDACTED] would have the largest interest in the LLC, he would receive the majority of the benefit of any available deduction. A small amount of any such deduction (in proportion to TNC's interest) would be allocable to TNC. The LLC would subsequently be dissolved, and the land, then encumbered by the conservation easement, would be distributed to [REDACTED] in satisfaction of his interest in the LLC.

Based on our preliminary research, we have identified three issues that may arise under this scenario, each of which is addressed below.<sup>1</sup> First, we consider whether the Internal Revenue Service (the "Service") would treat the transaction as, in substance, the equivalent of the sale of property subject to a restriction and thus deny [REDACTED] the benefit of any subsequent appreciation in value. Next, we consider the potential effect of the arrangement on the valuation of the land. Finally, we consider whether the arrangement could cause TNC to recognize unrelated business taxable income or jeopardize TNC's tax-exempt status under the charitable joint venture rules.

---

<sup>1</sup> Our research to date has been limited to issues relating to the availability of a charitable contribution, the impact of the structure of the transaction on the amount of any contribution and the potential tax implications for TNC. We have not undertaken any research with respect to the issues of allocation of profit or loss or distributions of property under Internal Revenue Code section 702, *et seq.*

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1. **Economic Substance of Transaction**

First, we believe there is risk that the Service would find the transaction described above to lack economic substance and, in reality, to involve the sale of encumbered property at a premium price (*i.e.*, a "bargain sale"). Therefore, we believe the arrangement could be treated for tax purposes in much the same manner as the option transaction discussed in our draft letter dated March 7, 2001.

In an analogous case, *Mount Mercy Associates v. Commissioner*, the Tax Court concluded that a purported charitable contribution by a partnership lacked economic substance and was thus not deductible. 67 T.C.M. 2267 (Feb. 24, 1994), *aff'd*, No. 94-4091 (2d Cir. Feb. 8, 1995) (unpublished opinion). In *Mount Mercy*, a partnership was formed to purchase land from a religious order. The partnership contracted to purchase from the order a parcel of unimproved land and a parcel of land upon which the order's convent was located. At closing, the partnership took control of the unimproved land and leased the convent property back to the order for \$1 per annum. Simultaneous with the sale and leaseback, the partnership conveyed to the order a 50 percent undivided interest in the convent property and claimed a charitable contribution. Eventually, the partnership transferred 48 percent interest in the convent property back to the order and claimed an additional charitable deduction in connection with the transfer.

The Tax Court concluded that the transfer and reconveyance of the convent property lacked economic substance.<sup>2</sup> The transaction was structured in such a way that the order never lost possession, control, or ownership of the convent property, as evidenced by the

---

<sup>2</sup> Although the Tax Court agreed with the Service's argument that the transaction lacked economic substance, the Tax Court rejected the Service's argument that the partnership's conveyance of the convent property was in exchange for an economic benefit and thus lacked donative intent. *Id.*

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lease and the fact that a mortgage note secured by the convent property was never paid. In essence, the partnership purchased only the unimproved land. Therefore, the partnership was not allowed a charitable deduction. *Id.*

The proposed LLC arrangement is similar to the transaction in *Mount Mercy* in that both transactions involve the transfer by a charitable organization of land to another entity with an expectation that a portion of the property or an interest in the property will be reconveyed to the charitable entity. Further, like the religious order in *Mount Mercy*, TNC arguably would not relinquish control of the property to the LLC because TNC would retain veto, or consent, rights with respect to any further transactions involving the land. However, to the extent there is a realistic possibility that the members would ultimately decide not to grant a conservation easement to TNC, there is less certainty that the Service would conclude that the LLC arrangement lacks economic substance. Nevertheless, there is a risk that the Service would reach such a conclusion and that ~~Murphy~~ would be denied the benefit of any further appreciation in the value of the property, with the result that any charitable deduction would be limited to the amount by which the purchase price paid by the LLC exceeds the fair market value of the property.

2. Valuation

Further, we believe there is risk that TNC's consent rights under the LLC agreement would constitute a restriction on the property that would depress the value of the property. In *Mount Mercy*, discussed above, the Tax court noted that although the partnership had no legal obligation to reconvey the convent property to the religious order, the order had essentially protected its interests through a highly favorable 10-year lease of the property. 67

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T.C.M. 2267. The Tax Court noted that the lease “substantially reduced the value of the convent property.” *Id.*

Similarly, TNC would arguably be protecting its interests in the land through its consent rights under the LLC agreement. This restriction is thus likely to depress the value of the land held by the LLC for charitable deduction purposes.

We recommend that you confirm the likely effects of the LLC arrangement on the value of the land with ~~XXXXXX~~.

**3. Charitable Joint Venture Issues**

Finally, where a section 501(c)(3) organization enters into a joint venture arrangement with a nonexempt third party in which the exempt organization will serve as a general partner of a partnership or a managing member of an LLC, the Service generally applies a two-part “close scrutiny” test to determine the permissibility of the joint venture arrangement. The two-part test requires (i) that the activities of the joint venture further charitable purposes; and (ii) that the structure of the venture insulates the exempt organization from potential conflicts between its charitable purposes and its obligations as a general partner or managing member, and minimizes the likelihood that the arrangement will generate private benefit. *See, e.g., Rev. Rul. 98-15, 1998-12 I.R.B. 6 (Mar. 4, 1998).*

Control will be determined based on all relevant facts and circumstances. With respect to the control requirement, it may be insufficient from the Service’s perspective to have 50% control and an ability to veto any significant transactions. For example, in Revenue Ruling 98-15, the Service set forth two different scenarios, one with “good facts” and one with “bad facts.” In the situation involving good facts, the exempt organization was entitled to select three members of the LLC’s governing board, while the nonexempt organization could select only two

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members of the governing board. As such, the exempt organization clearly controlled the joint venture. In the "bad facts" scenario, each party selected two members of the governing board. The Service concluded that, based on the control situation and all other relevant facts and circumstances, the organization in the good facts scenario was entitled to exemption, while the organization in the bad facts scenario was not. Some commentators believe that the Service considers a 50-50 control arrangement to be insufficient (even though the organization could temporarily block actions proposed by the for-profit) because the exempt organization is essentially powerless to force the joint venture to take affirmative actions that it considers essential to meeting its charitable purposes.

Importantly, the hypothetical joint ventures at issue in Revenue Ruling 98-15 were "whole hospital" joint ventures, and thus involved the transfer of *all* of the exempt organization's activities into the joint venture. As was the case in Revenue ruling 98-15, in the case of a "whole-entity" joint venture that is found not to operate in furtherance of charitable purposes, the likely result is loss of the organization's exemption.

There has been considerable speculation concerning whether the Service will also apply the analysis of Revenue Ruling 98-15 in the context of an "ancillary" joint venture, i.e., one that does not involve all of the exempt organization's operations. However, because an ancillary joint venture does not involve all of the operations of an exempt organization, if the venture is found not to further charitable purposes because of a lack of overriding charitable purpose or because the organization has ceded control of the venture to a nonexempt entity, the organization may only incur unrelated business income tax rather than loss of its exemption.

Although the Service has not explicitly extended Revenue ruling 98-15 to cover ancillary joint ventures, it appears that the Service applies a similar analysis to such ventures.

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For example, in Private Letter Ruling 200041038, the Service condoned participation of a conservation organization in an LLC that could be regarded as an ancillary joint venture. The Service ruled that the management role of the organization in the timber management and selling venture would not impair its section 501(c)(3) status because the venture furthered its conservation purposes by managing the timber rights of a number of small holders on a more ecologically sensitive and sustainable basis than the individual donors had done. The operating agreement explicitly provided that in the event of a conflict between the purpose of conserving forestland and managing the lands to provide economic benefits to the members, conservation will control. The exempt organization could only be replaced as manager by extraordinary measures (a two-thirds vote of the members after failure to provide for the annual minimum return to the participants for two consecutive years) and then must be replaced by another exempt organization.

Until the Service issues clear guidance with respect to ancillary joint ventures, at least one commentator has recommended that exempt organizations take the following precautionary steps when entering into joint ventures with nonexempt parties:

1. Enter into ancillary ventures that clearly further the organization's exempt purposes;
2. Have the exempt organization make a capital contribution proportionate and equal to its percentage interest in the ancillary venture;
3. Recognize that cash contributions may be less risky than asset contributions;
4. The exempt organization should have more than minimal equity ownership even if it otherwise controls the ancillary venture;

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5. Add an express requirement to the operative documents of the ancillary venture that in the case of any conflict between the exempt organization's obligations to satisfy the charitable purpose and furtherance of profit-making goals that the former will prevail; and
6. Limit the exempt organization's obligation to fund future capital contributions to the ancillary venture, and strive to minimize its exposure to liability as a general partner.

M.I. Sanders, *Current Issues in Structuring Joint Ventures*, Representing and Managing Tax-Exempt Organizations, Georgetown University (Apr. 26-27, 2001).

It is conceivable that the proposed TNC ~~LLC~~ LLC could be deemed to operate with the charitable purpose of conservation, although the management agreement presumably would not explicitly provide that conservation considerations will override any nonexempt considerations. Nevertheless, because TNC presumably would not have more than 50% control of the proposed LLC, there is risk that TNC will be deemed to have ceded control of the activity to a nonexempt interest. Therefore, participation in the LLC may not constitute an appropriate section 501(c)(3) activity. Because of the overall level of activities in which TNC engages, however, it is unlikely that this venture alone, even if deemed unrelated to TNC's exempt purposes, would place TNC's exempt status at risk. Instead, TNC likely would incur unrelated business income tax in connection with any income from the activity. If, on the other hand, TNC intends to use the LLC structure as a model for future transactions and the transactions, taken together, are more than insubstantial, participation in such ventures could place TNC's exempt status at risk.

contributions: Deductions: Economic substance: Benefit to donor.--, (Feb. 24, 1994)  
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[CCH Dec. 49,693(M)]

Mount Mercy Associates, Alan Berk, Tax Matters Partner v. Commissioner

Docket No. 11191-90., TC Memo. 1994-83, 67 TCM 2267, Filed February 24, 1994

[Appealable, barring stipulation to the contrary, to CA-2.--CCH.]

[Code Sec. 170.]

Charitable contributions: Deductions: Economic substance: Benefit to donor.--A partnership was not entitled to claim charitable contribution deductions for the donation of property to a religious order. The partnership contracted to purchase from the order unimproved land and a parcel of land upon which a convent was located. Following the purchase, the partnership took control of the unimproved land and leased the convent property back to the order, and, eventually, it transferred the convent property back to the order. This transfer and reconveyance of the convent property lacked economic substance. The transaction was structured in such a way that the order never lost possession, control, or ownership of the convent property, as evidenced by the fact that the mortgage note secured by the convent property was never paid. In essence, the partnership purchased only the unimproved land. Therefore, no charitable deduction was allowed.--CCH.

Leonard Rosen (specially recognized), for the petitioner. Randall P. Andreozzi, for the respondent.

#### Memorandum Findings of Fact and Opinion

GERBER, Judge:

Respondent, by means of a Notice of Final Partnership Administrative Adjustment (FPAA), determined adjustments to Mount Mercy Associates', a limited partnership (partnership), income for its 1985 and 1986 taxable years in the amounts of \$1,534,738 and \$1,473,348, respectively. The adjustments are attributable to respondent's disallowance of deductions claimed for a charitable contribution.

We must decide whether the partnership's conveyances of real property and a convent building in 1985 and 1986 qualify as charitable contributions under section 170<sup>1</sup> and, if so, the fair market value of the property contributed.

#### Findings of Fact

Some of the facts have been stipulated, and the stipulation of facts and attached exhibits are incorporated by this reference. At the time of filing the petition herein, the partnership had its principal place of business in Dobbs Ferry, New York.

The partnership was formed on October 8, 1985, to acquire property located in Dobbs Ferry, New York, and to build residential units on the property. At that time, the property was owned by the Institution of Mercy (Corp.), a not-for-profit, eleemosynary corporation wholly owned by the Sisters of Mercy (Sisters), a religious order.

The corporation offered approximately 35<sup>2</sup> acres of land for sale, through a real estate agent, at a \$7.5 million asking price. The Sisters resided at and operated a nursing home in the Mount Mercy convent building, which was an improvement on the property offered for sale. The convent building and surrounding grounds were situated on approximately 5 acres of land (the convent property). The corporation prescribed certain terms or conditions that were to be included before an offer to purchase the property would be considered. The offer must, to some extent, be paid in cash and the remaining mortgage note would not be subordinated to any other financing. No personal property was to be included in the offer and the Sisters desired continued use of the convent building. The Sisters occasionally attended negotiations or meetings, but the interests of the corporation and the Sisters were represented by lawyers. The corporation had financial needs which motivated its proposal to sell the realty. The primary concerns of the Sisters were to generate some operating funds and to retain use of the convent building in order to carry out their charitable activities.

The partnership's Private Placement Memorandum outlined plans to purchase the property from the corporation. There were no plans to develop the convent property. Instead, the partnership intended to build up to 250 luxury condominiums on the remaining unimproved property. It was anticipated and understood that the partnership intended to deed the convent property back to the corporation. The Private Placement Memorandum outlined the tax benefits to the investors attributable to donating the convent property. To maximize the anticipated tax benefits, 50 percent of the convent property was to be donated in 1985 and the remainder in 1986.

The negotiated purchase price in the initial draft of the purchase agreement between the corporation and Geyglu Corp. (Geyglu) (the partnership's initial general partner) was \$8 million (\$3,250,000 cash and a \$4,750,000 purchase money note and mortgage). The corporation received other offers to purchase the property. The offers ranged from \$6 million to \$7.5 million and almost all provided for some arrangement under which the Sisters would remain in the convent property. Only one offer did not provide for the Sisters to remain in the convent property.

contributions: Deductions: Economic Substance: Benefit to donor.-- (Feb. 24, 1994)  
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The November 1, 1985, purchase and sale agreement contained a \$9 million selling price payable \$2 million at closing; a \$1 million note and mortgage secured by the convent property; and a \$6 million note and mortgage secured by the remaining unimproved land. The agreement also stated that upon closing, Geygh would lease the convent property back to the corporation. Geygh assigned its rights and obligations to the partnership under the purchase and sale agreement on November 30, 1985.

After the purchase and sale agreement was signed, the partnership renegotiated the provisions of the sale with the corporation. The purchase price remained at \$9 million but cash to be paid at closing was reduced from \$2 million to \$400,000, and the \$6 million note and mortgage were correspondingly increased to \$7.6 million. The corporation agreed to subordinate the \$1 million mortgage note secured by the convent property. During these negotiations, the partnership discussed its intentions to donate the convent property with representatives of the corporation.

In November 1985, the partnership hired a real estate appraiser to determine the fair market value of the property. The convent property was appraised separately from the unimproved land. The appraiser opined that the fair market values of the convent property and the remaining unimproved land were \$4 million and \$6.9 million, respectively.

On December 30, 1985, the corporation conveyed the property to the partnership for \$9 million under the following terms: \$80,000 deposit paid November 1, 1985; \$10,000 additional deposit paid December 1985; \$310,000 paid December 30, 1985; \$1 million note and mortgage secured by the convent property; and \$7.6 million note and mortgage secured by the remaining unimproved property. The \$7.6 million note and mortgage was nonrecourse and had an interest rate equal to the greater of 10 percent or 2 percent plus the prime commercial rate of The Bank of New York. The \$1 million note and mortgage was nonrecourse, had no stated interest rate, and was subordinate to all mortgages which existed at the closing or arose thereafter. Payment of the \$1 million note was due on December 30, 1988.

Also on December 30, 1985, the partnership leased the convent property back to the corporation. The lease was for 3 years, with renewals for 7 additional years (maximum of 10 years), at \$1 per annum rent. Simultaneous with the sale and leaseback, the partnership conveyed to the corporation a 50-percent undivided interest as tenants in common in the convent property. The corporation granted the partnership a right of first refusal with respect to any subsequent sale, lease, transfer, or other conveyance of its interest in the convent property. The partnership claimed a \$1,534,738 charitable contribution deduction on its 1985 tax return attributable to its conveyance of 50 percent of the convent property to the corporation.

On December 24, 1986, the partnership conveyed an additional 48-percent undivided interest, in the convent property, to the corporation as tenants in common. The corporation granted the partnership a right of first refusal, under the same terms as the 50-percent transfer, with respect to its 98-percent undivided interest in the convent property. The partnership retained a 2-percent undivided interest in the convent property. The partnership claimed a \$1,473,348 charitable contribution deduction on its 1986 tax return attributable to its conveyance of a 48-percent interest in the convent property to the corporation.

The \$1 million nonrecourse note and mortgage secured by the convent property was due on December 30, 1988. As of the due date and through the time of trial, the partnership had not paid any part of the \$1 million nonrecourse note and the corporation had not demanded payment or attempted to collect on the \$1 million note. The partnership has paid the principal and monthly interest on the \$7.6 million mortgage note secured by the remaining unimproved property. As of July 15, 1989, \$5.6 million of the \$7.6 million note had been paid by the partnership.

At the time of the sale, the entire property was zoned for educational institution use. The partnership sought to change the zoning of the unimproved land to a one family residence district. The partnership did not attempt to change the zoning for the convent property. In its zoning application, the partnership represented that it paid \$9 million for the unimproved land without reference to the convent property. At all times pertinent herein, the Sisters indicated that they did not intend to leave the convent property and that their intention was to remain indefinitely. During 1986, the Sisters requested a zoning change for the convent property to a convent zone.

### Opinion

The issue for our consideration is whether the partnership was entitled to claim charitable contributions in 1985 and 1986 and, if so, the amount of the contributions. Petitioner bears the burden of proving that the partnership is entitled to the claimed deductions. Rule 142(a).

Section 170, in general, allows a deduction for a charitable contribution made during a taxable year. Section 170(c) defines a charitable contribution as a "contribution or gift to or for the use of" an organization as described in that section. Both parties agree that the corporation is such an organization. When a taxpayer contributes property rather than cash, the amount of the charitable contribution deduction is generally the fair market value of the property at the time of the contribution. Sec. 170A-1(c)(1), Income Tax Regs.

A charitable contribution is synonymous with a gift. *Sutton v. Commissioner* [Dec. 31, 075], 57 T.C. 239, 242 (1971). A gift is defined as a voluntary transfer of property motivated by a detached and disinterested generosity. *Commissioner v. Duberstein* [60-2 USTC ¶9515], 363 U.S. 278, 285 (1960). If a transfer is motivated by an anticipated economic benefit

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from the donee, even if there is no legal or moral obligation, then it is not a gift. *Id.*; see *Hernandez v. Commissioner* [89-1 USTC ¶9347], 490 U.S. 680, 690-691 (1989).

Respondent first argues that the closing documents, on their face, show that the transfer of the convent property to the corporation was a bargained for exchange and an integral part of the entire transaction; therefore, it was not a gift. Respondent contends that the partnership conveyed the convent property in expectation of economic benefits from the corporation; namely the conveyance of the unimproved property.

We find that the partnership's primary motivation for conveying the property was to secure a tax deduction. However, this does not result in the disallowance of the deduction. "A charitable contribution may be motivated by the basest and most selfish of purposes as long as the donor does not reasonably anticipate benefit from the donee in return." *Weitz v. Commissioner* [Dec. 45,526(M)], T.C. Memo. 1989-99 (citing *Stubbs v. United States* [70-2 USTC ¶9468], 428 F.2d 885, 887 (9th Cir. 1970)). "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory v. Helvering* [35-1 USTC ¶9043], 293 U.S. 465, 469 (1935) (citations omitted).

We do not find that partnership's conveyance of the convent property was in exchange for an economic benefit from the Sisters or the corporation. As a matter of form, the partnership was under no obligation to transfer the convent property, even though it was understood that it intended to do so. The partnership made its intentions clear in its Private Placement Memorandum and during the negotiations for the purchase of the property. This does not automatically disqualify a conveyance from being a gift.

The corporation may have expected to receive the property, but, because the partnership had no legal obligation to transfer the convent property, the corporation protected its interests. The protection was in the form of a highly favorable 10-year lease. This 10-year lease, with a nominal stated annual rental, substantially reduced the value of the convent property. In addition, the corporation held a mortgage note secured by the convent property. Even if the partnership had not conveyed the convent property, the Sisters could have remained on the property without interruption. We are unable to find, as respondent argues, that the corporation would not have sold the partnership the property if it had not agreed to transfer back the convent property or that the conveyance was a bargained-for exchange.

Respondent next argues that the contribution lacks economic substance. In order to have economic substance, the form of the transaction must comport with the underlying reality. A transaction that lacks economic substance should be disregarded for Federal tax purposes. *Gregory v. Helvering*, *supra*. "A given result at the end of a straight path is not made a different result because reached by following a devious path." *Minnesota Tea Co. v. Helvering* [38-1 USTC ¶9050], 302 U.S. 609, 613 (1938).

Respondent asserts that the underlying reality of the transaction was such that the partnership purchased only the unimproved land and did not purchase the convent property. Respondent contends that the partnership paid \$8 million for the unimproved land and not \$9 million for the convent property and the unimproved land. To support that contention, respondent points to the fact that the \$1 million mortgage note was not paid when due and that payment was not demanded. Further, the partnership, in its zoning application, represented that the \$9 million was paid for the unimproved land, and the purchase and reconveyance of the convent property was not referenced in the application.

Petitioner argues that the convent property was purchased as part of the transaction. Petitioner asserts that because the partnership did not intend to utilize the convent property and instead intended to contribute the property back to the corporation it does not automatically follow that the transaction lacked economic substance. Petitioner relies on *Weitz v. Commissioner*, *supra*. In *Weitz*, the taxpayers purchased medical supplies at a discount, held the supplies for 1 year, and then donated them to a hospital and took a charitable contribution deduction. The transaction was done through an agent and was motivated primarily to secure a tax deduction. The taxpayers did not know what equipment was purchased, where it was stored, or to whom it would ultimately be donated. The Commissioner challenged the deduction claiming that the transaction lacked economic substance. This Court held that the taxpayers were entitled to the charitable contribution deduction after deciding that the transfer of the supplies was a gift, that the agent did represent the taxpayers and not the hospitals, and that the taxpayers were the true owners of the supplies. *Weitz v. Commissioner*, *supra*.

The Court in *Weitz*, as part of its holding that the transaction had economic substance, discussed that the taxpayers had the right to beneficial ownership of the property, although they did not exercise that right. See also *Skipak v. Commissioner* [Dec. 41,907], 84 T.C. 285, 316 (1985). During the year the taxpayers held the supplies, the hospital that was to receive the supplies could not use the supplies, even though they were stored in the hospital's warehouse. At any time during that year, the taxpayers could have withdrawn from the plan and taken possession of the medical supplies.

The partnership here, however, did not intend to take possession of the convent property. Instead, it intended to donate the convent property back to the corporation. The corporation expected to receive the property when the transaction was complete. Simultaneous with the purchase of the property, the convent property was leased for a \$1 per annum rental and a 50-percent undivided interest in the leased property was also conveyed to the corporation.<sup>3</sup> The following year, the partnership conveyed a 48-percent undivided interest in the convent property. At all relevant times, the Sisters had uninterrupted use and enjoyment of the convent property, and the corporation had at least a 50-percent ownership interest.

contributions: Deductions: Economic substance: Benefit to donor.--, (Feb. 24, 1994).  
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The partnership did not have or exercise any possessory right to the convent property. In substance, the Sisters and the corporation never lost possession, control, and, in essence, ownership of the convent property.

Furthermore, the mortgage note secured by the convent property was not paid, even though all other obligations concerning the transaction were being fully executed. The partnership's representative, in a sworn affidavit attached to its zoning application, represented that it purchased the unimproved land, but not the convent property, for \$9 million. Evidently the partnership did not allocate any portion of the purchase price or basis to the convent property. Unlike the taxpayers in *Weitz*, the partnership, in substance, did not become the true owner of the convent property.<sup>4</sup>

The substance of the transaction, considered in its entirety, is that the partnership purchased only the unimproved land for \$8 million. The \$8 million purchase price is within the range of the other offers that had been made to acquire the property. Although the face value may appear to be higher than other offers, the offer is comparable especially if one considers the contract modifications reducing the amount of cash up front by \$1.6 million and deferring payment of that amount for a period of years. The transfer and reconveyance of the convent property was without economic substance, and the partnership did not possess the benefits and burdens of ownership in the convent property. The partnership played on the charitable presence and good reputation of the Sisters to structure a transaction which had the appearance, but not the substance, of a gift to charity. The form of the transaction, if respected, would have allowed the partnership a deduction that was designed merely to reduce its cost of acquiring the unimproved land.<sup>5</sup> We agree with respondent that section 170 was not intended to encourage profit-motivated entities to enter into this type of structured transaction. The partnership's purchase of an unwanted and unnecessary asset with no additional cost to it should not result in a tax benefit where none was actually intended by the statutes or, as a matter of substance, the donee received nothing more than it already possessed. The Sisters made clear their intent to sell the property and also to remain in possession of the convent property to continue their charitable endeavors. They played a passive role in this transaction, except for the acceptance of a sales price and the requirement that they remain in possession. It was the partnership that produced the subterfuge we must ignore. Therefore, we find that the contribution lacked economic substance, and the partnership is not entitled to charitable deductions for 1985 and 1986.<sup>6</sup>

*Decision will be entered for respondent.*

<sup>1</sup> All section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

<sup>2</sup> Some documents presented at trial indicate that there were approximately 44 acres plus the convent property sold to the partnership. Approximately 15 acres of the property were situated on the Hudson River. Therefore, there were approximately 35 acres of usable property offered for sale. We note that the different references to the amount of property exchanged does not affect our decision in this case.

<sup>3</sup> Even if the partnership had failed or refused to convey the convent property, its value was substantially decreased because of the bargain lease to the corporation. We further note that the bargain lease was not a gift or contribution because it was bargained for and became part of the legal obligations of the parties. Therefore, the convent property had little commercial value and the only way the transaction makes sense is if the partnership gave the land to the corporation.

<sup>4</sup> Some indications of ownership include:

(1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. \* \* \*

*Grod & McKay Realty, Inc. v. Commissioner* [Dec. 38,472], 77 T.C. 1221, 1237-1238 (1981) (citations omitted).

<sup>5</sup> With the expected charitable contribution deductions, the investors expected to pay less than \$8 million for the unimproved land. Assuming a 50-percent top marginal rate for the investors, they may have expected the deductions to yield an additional \$1.5 million. Considering the tax effect, the partnership would have only paid \$6.5 million for the unimproved property, which is less than the \$6.9 million fair market value estimated by the real estate appraiser the partnership hired before it entered into the transaction.

<sup>6</sup> Having found that the claimed contribution lacked substance, it is unnecessary to decide the fair market value of the convent property at the time of the alleged gift.

Commissioner of Internal Revenue, Respondent, Charitable contributions: Deductibility: Economic substance.  
(Feb. 08, 1995)

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[95-1 USTC ¶50,164] Mount Mercy Associates, Alan Berk, Tax Matters Partner, Petitioner v. Commissioner of Internal Revenue, Respondent

(CA-2), U.S. Court of Appeals, 2nd Circuit, 94-4091, 2/8/95, 50 F3d 2, Affirming the Tax Court, 67 TCM 2267, Dec. 49,693(M), TC Memo. 1994-83

[Code Sec. 170 ]

**Charitable contributions: Deductibility: Economic substance.**--A partnership was not entitled to claim charitable contribution deductions for the donation of property to a religious order. The partnership contracted to purchase from the order unimproved land and a parcel of land upon which a convent was located. Following the purchase, the partnership took control of the unimproved land and leased the convent property back to the order. It eventually transferred the convent property back to the order. This transfer and reconveyance of the convent property lacked economic substance. The transaction was structured in such a way that the order never lost possession, control and ownership of the convent property, as evidenced by the fact that the mortgage note secured by the convent property was never paid. In essence, the partnership purchased only the unimproved land; therefore, no charitable deduction was allowed. **BACK REFERENCES:** 95FED ¶11,690.051

→ **Caution:** This court has designated this opinion as **NOT FOR PUBLICATION**. Consult the Rules of the Court before citing this case. ←

Present: FEINBERG, MESKILL, MCLAUGHLIN, Circuit Judges.

ON CONSIDERATION WHEREOF, it is hereby ordered, adjudged

, and decreed that the judgment of the Tax Court be and it hereby is **AFFIRMED**.

Mount Mercy Associates appeals from a decision of the United States Tax Court that it was not entitled to charitable deductions claimed in its tax returns for 1985 and 1986. We affirm the Tax Court's conclusion that there was no economic substance to the transaction underlying the deductions.

The decision of the Tax Court is **AFFIRMED**.

Pinna, Johnston & Burwell, P.A.

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May 22, 2000

Hans Birle, Esquire  
The Nature Conservancy  
201 Devonshire Street, 5<sup>th</sup> Floor  
Boston, Massachusetts 02110

***Via E-Mail and First Class Mail***

Re: Wildlife Management, L.L.C. Contract

Dear Hans:

I am writing to you on behalf of Wildlife Management, L.L.C. and [REDACTED] with respect to the Option for Purchase of Real Estate from [REDACTED] as Trustee under trust agreement dated November 30, 1982. Specifically, I have been advising the above parties with respect to the tax consequences of this transaction. I request the language under Section 3 entitled "Purchase Price" be amended to reflect the following:

1. The purchase price be determined by MAI appraiser selected by Buyer.
2. That no reference be made to any \$50,000 cash donation, but simply that a \$50,000 check will be written and received by The Nature Conservancy prior to the execution of the Option which anticipates a \$2,000 payment.
3. That contemporaneously with the execution of the Option, a single or double letter(s) of credit will be delivered to The Nature Conservancy for an agreed upon amount which will expire subsequent to the expiration of the 14 month option period.
4. The letter of credit will be available to be drawn upon, if Wildlife Management, L.L.C. exercises its option within the option period at the MAI appraised value without a donation of the difference of \$1,000,000 and the appraised value to The Nature Conservancy.

Hans Birle, Esquire  
May 22, 2000  
Page - 2-

5. If the donation is made to The Nature Conservancy by [REDACTED], then the letters of credit will be released and the closing on the property can take place at the fair market value as determined by the MAI.
6. There should be no reference to a promissory note or deed of trust since financing will not be necessary.

By modifying the Option accordingly, I feel it is clearer as to any charitable donation to a qualified charity without the necessity of our firm reviewing the trust agreements as to charitable content along with the fact our client, [REDACTED], has a clear donation to a qualified charity with the same results to The Nature Conservancy.

If you can agree to modify the Option accordingly, I will instruct our clients to proceed with securing and delivery of letter(s) of credit.

Thank you for your consideration and please feel free to contact me at the above address.

Very truly yours,

PINNA, JOHNSTON & BURWELL, P.A.

[REDACTED SIGNATURE]

WPP/dbm

cc: [REDACTED]

**STEPTOE & JOHNSON LLP**

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**DELIVER TO:**

NAME: [REDACTED], Esq.  
Legal Counsel

TELECOPY PHONE NUMBER: (617) 482-5868

COMPANY: Northeast Division of  
The Nature Conservancy

VERIFICATION NUMBER: (617) 542-1908 x. 218

TOTAL PAGES &amp; COVER SHEET: 8

DATE TRANSMITTED: 9/26/2002

S&amp;J OPERATOR'S NAME: [REDACTED]

TELEPHONE NUMBER: (202) 429-6436

CLIENT/CASE NUMBER: [REDACTED]

**FROM:**

NAME: [REDACTED] direct dial [REDACTED]

REQUEST MADE ON

DATE: 9/26/02

TIME: 3:47 PM

COMPLETION REQUIRED BY

DATE: 9/26/02

TIME: ASAP

**SPECIAL INSTRUCTIONS:**

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September 26, 2002

*via Facsimile and U.S. Post*

Michael Dennis, Esq.  
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The Nature Conservancy  
4245 Fairfax Drive  
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Hans P. Birle, Esq.  
Legal Counsel, Northeast Division  
The Nature Conservancy  
201 Devonshire Street  
Boston, Massachusetts 02010

**Re: Deductibility of the Amounts Paid for Property  
Purchased from a Charity at a Premium**

Dear Mike and Hans:

You have requested that we update our opinion letter of March 10, 1997, which discussed the tax consequences of the sale of certain tracts of land by The Nature Conservancy ("TNC")<sup>1</sup> at a premium. We concluded that a potential purchaser would be entitled to a charitable deduction for the premium payment.

In the present letter we do not discuss any specific transaction but, rather, address the current rules that apply generally to charitable contributions involving a purchase of property from a charity for more than the fair market value of the property.

**I. Allowance of Charitable Deduction for Premium Paid**

A purchaser who pays a premium to purchase property from TNC should be entitled to a charitable deduction under Section 170(a) of the Code for the amount paid in excess of the fair market value of the property. The landmark case addressing the deductibility of amounts paid for purchases of property from charities is United States v. American Bar

<sup>1</sup> TNC is a public charity described in section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code").

Michael Dennis, Esq.  
Hans P. Birle, Esq.  
September 26, 2002  
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Endowment, 477 U.S. 105 (1986). In American Bar Endowment, the United States Supreme Court specifically recognized that a payment to charity can have the dual character of a purchase and a contribution. The American Bar Endowment ("ABE") raised funds for its exempt activities by providing group insurance policies, underwritten by insurance companies, to its members. Because of ABE members' low mortality and morbidity rates, the cost to the insurance companies of providing insurance to ABE members was uniformly lower than the premium paid in a given year. The excess, called a dividend, was refunded to ABE in its capacity as the master policyholder for its members. All members were required to assign all policyholder dividends to ABE as a condition of participating in the insurance program. ABE used the dividends for its charitable purposes. ABE advised its insured members that each member's share of the dividends, less ABE's administrative costs, constituted a tax-deductible contribution. The Court held that a charitable deduction for such dividends was not available because the premium paid did not exceed the fair market value of the insurance received. The Court, however, made clear that the result would be different if the amount paid exceeded the fair market value of the benefit received in return:

Where the size of the payment is clearly out of proportion to the benefit received, it would not serve the purposes of §170 to deny a deduction altogether. A taxpayer may therefore claim a deduction for the difference between a payment to a charitable organization and the market value of the benefit received in return, on the theory that the payment has the "dual character" of a purchase and a contribution.

Id. at 117. See also Treas. Reg. § 1.170A-1(d) (allowing a charitable deduction for amounts paid to charities for annuity contracts in excess of their fair market value); Rev. Rul. 70-15, 1970-1 C.B. 20 (same); Rev. Rul. 67-246, 1967-2 C.B. 104 (allowing a charitable deduction for the price of a ticket to a charity ball to the extent that the price exceeded the fair market value of admission).

To determine whether a part of a dual payment is deductible, courts and the Internal Revenue Service (the "Service") use the following two-part test. First, the payment is deductible only if and to the extent it exceeds the market value of the benefit received. Second, the amount in excess of fair market value must be paid with the intention of making of gift. American Bar Endowment, 477 U.S. at 117. This two-part test was first articulated in Rev. Rul. 67-246, supra. In 1997, this test became incorporated in its entirety in Treas. Reg. section 1.170A-1(h)(1). See T.D. 8690 IRB 1997-5.

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The amount deductible for dual payments is limited to the excess of:

- the amount of any cash paid and fair market value of any property (other than cash) transferred by the donor to a charity over
- the fair market value of the goods or services the organization provides in return.

Treas. Reg. §1.170A-1(h)(2)(i).

In PLR 200213021 (Dec. 14, 2001), the Service applied the two-part test to a fund-raising activity of a tax-exempt church. In that ruling, Taxpayer, a church, constructed a columbarium on the church's property. The columbarium included niches for the interment of cremated remains and cenotaphs for the remembrance of those buried elsewhere. Taxpayer offered its members the opportunity to purchase the right to use the niches and cenotaphs at a price significantly exceeding the fair market value of the niches and cenotaphs. Each purchaser executed a Donor's Agreement which set forth the fair market price for the niches and cenotaphs. The Donor's Agreement made clear that Taxpayer would not furnish any goods or services customarily offered by funeral homes. The Service concluded that the amounts in excess of the fair market value of the niches and cenotaphs qualified for a charitable deduction because the donors were properly informed, by way of the Donor's Agreement, that the fair market value of the benefits being purchased was \$d for a niche and \$e for a cenotaph and that only the amount in excess of the fair market value was being solicited as a gift.

The charity should determine the amount of payment attributable to the purchase of privileges or benefits and the amount solicited as a gift in advance of the solicitation. Rev. Rul. 67-246, *supra*. The charity must notify its donors of the amounts allocable to the purchase component and the contribution component of the payment. Rev. Rul. 67-246, *supra*; Rev. Proc. 90-12, 1990-1 C.B. 471. The donor may rely on the charity's good faith estimate of the fair market value of the property provided by the charity in return for the donor's contribution. Treas. Reg. §1.170A-1(h)(4).

Thus, if TNC sells any property at a price in excess of the property's fair market value, the premium payment will be deductible to the purchaser under Section 170(a) of the Code so long as the transaction makes clear that the purchaser intends to make a gift to TNC of the premium amount.

## II. Additional Limitations

If all or part of the donor's premium payment to TNC consists of property other than cash, the amount of the charitable deduction will be subject to the limitations provided in sections 170(b)(1)(C)(i) and 170(c) of the Code and sections 1.170A-4 and 1.170A-4A of the regulations. See Treas. Reg. §1.170A-1(h)(2)(ii).

**A. Reduction in the Amount of the Contribution**

Generally, the amount of charitable deduction allowable for a contribution of property other than cash is the fair market value of the property at the time of the contribution. Treas. Reg. §1.170A-1(c)(1). Fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither of whom was under any compulsion to buy or sell and both of whom had reasonable knowledge of the relevant facts. Treas. Reg. §1.170A-1(c)(2). The fair market value of contributed property is determined by taking into consideration "the most active and comparable market place at the time of the donor's contribution," and the restrictions, if any, placed on the property by the donor. Rev. Rul. 80-233, 1980-2 C.B. 69; Rev. Rul 85-99, 1985-2 C.B. 83. Evidence of the donated property's value includes:

- valuation by a qualified appraiser;
- the donor's cost of purchasing the property, if the purchase occurs shortly before the donation;
- the sale price obtained by the donee in a resale, if the resale occurs shortly after the donation;
- market sales price of comparable property.

See Dillard v. Commissioner, 20 T.C.M. (CCH) 137 (1961); Rev. Rul. 80-69, 1980-1 C.B. 55.

The charitable contribution deduction for gifts of property other than cash is required to be reduced by the amount which would not have been long-term capital gain if the property had been sold by the taxpayer at its fair market value at the time of the contribution. Code §170(e)(1)(A). The determination of whether an asset would produce long-term capital gain depends on (1) whether the asset is a capital asset under the Code and (2) whether the asset was held for a requisite period of time. Capital assets are defined as any property held by a taxpayer other than property expressly excluded from the definition of capital asset by section 1221 of the Code. Code §1221(a). Assets excluded from the definition of capital asset by section 1221 include property such as inventory, depreciable property used in the donor's trade or business and accounts receivable.<sup>2</sup> The holding period necessary to produce long-term capital gain is one year. Code §1222(3). Because the entire gain from a sale of an asset that (1) does not meet the definition of capital asset or (2) has not been held for at least one year, would be

<sup>2</sup> For charitable deduction purposes, property which is used in a donor's trade or business, except for the amount claimed as depreciation on such property, is treated as a capital asset, even though section 1221(a)(2) of the Code excludes such property from the definition of capital asset. Code §170(e)(1)(flush language).

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ordinary income, a contribution of this type of asset would be deductible only in the amount of the donor's basis in the asset. Code §170(e)(1)(A).

Even capital assets held for more than one year, however, are not necessarily entitled to the full fair market value deduction. Certain provisions of the Code require capital gain to be treated as ordinary income. Capital gain recharacterized as ordinary income under applicable provisions of the Code is not allowable as a charitable deduction. Section 1245(a)(1) of the Code provides that, in the case of a sale or other disposition of depreciable tangible property, the amount previously claimed as depreciation on such property is treated as ordinary income (not to exceed the taxpayer's actual gain on the sale or disposition of such property). Treas. Reg. Section 1.170A-4A(d) provides that a charitable deduction is not allowed for any amount treated as ordinary income under section 1245. The interplay of section 170(e)(1)(A) and section 1245 means that depreciable tangible property which is subject to depreciation recapture under section 1245 is deductible only in the amount of the property's fair market value minus the amount of the depreciation recapture.

Accordingly, if a donor's contribution to TNC consists of property that (1) does not meet the definition of a capital asset under section 1221 or section 170(e)(1)(flush language) of the Code; or (2) has not been held for at least one year; or (3) produces capital gain that is recharacterized as ordinary income under applicable provisions of the Code, the amount of the donor's charitable deduction for the contribution of such property will have to be reduced under section 170(e) of the Code, as described above.

#### B. Allocation of Basis

If a donor's payment consists of both cash and appreciated property, the contribution of property is likely to be treated as a bargain sale to a charity. See Code §1011(b). Ordinarily, the term "bargain sale" refers to a sale of property by a donor to a charity at below the property's fair market value rather than to a sale of property by a charity to a donor at above the property's fair market value. Nevertheless, in P.L.R. 8305075 (Nov. 3, 1982), the Service held that a sale of an annuity by a charity to a donor for more than the annuity's fair market value was a bargain sale. In exchange for the annuity, the donor in P.L.R. 8305075 transferred to the charity his interest in a certain farm. The Service held that the excess of the fair market value of the interest in the farm over the fair market value of the annuity was deductible as a charitable contribution. The Service also held that, in determining the amount of gain resulting from the bargain sale, the donor had to allocate its basis in the donated property between the sale element and the gift element, as required by section 1011(b) of the Code. The result of the basis allocation is the increase in the donor's taxable gain recognized on the exchange. Because the donor's entire payment in P.L.R. 8305075 consisted of appreciated property, the Service did not need to address how the basis allocation rules would apply to payments consisting of both appreciated property and cash.

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The rules for allocating basis are provided in Treas. Reg. section 1.1011-2(b). That regulation provides that the adjusted basis of the property which is sold or exchanged is that portion of the adjusted basis of the entire property which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the entire property. The application of this rule is straightforward in situations where the donor's entire payment consists of appreciated property so that the entire amount realized is attributable to that property. It is not so straightforward in situations involving payments consisting of both cash and property. Presumably, because the amount realized in exchange for a payment consisting of both cash and property is attributable to both cash and property, the amount realized has to be allocated between the cash and the property before the rule of Treas. Reg. section 1.1011-2(b) can be applied. Considering that the fair market of cash is its face value, the basis attributable to the sale portion of the transaction can then be calculated as follows:

$$\frac{\text{basis of the portion sold}}{\text{basis of the entire property}} = \frac{(\text{amount realized} - \text{cash})}{\text{fair market value of the entire property}}$$

### C. The 30% Ceiling on Deductions by Individual Donors in a Single Year

In the case of individuals, charitable contributions to tax-exempt public charities, such as TNC, are normally deductible to the extent of 50% of the donor's adjusted gross income, determined without regard to net operating loss carrybacks. Code §170(b)(1)(A). However, in the case of charitable contributions by individuals of capital gain property, the total amount of the charitable deduction is limited to 30% of the donor's adjusted gross income. Code §170(b)(1)(C)(i). The 30% ceiling applies only to contributions of capital gain property the fair market value of which is not required to be reduced under section 170(e) of the Code. See I.B.1, *supra*. The amount of the contribution in excess of 30% of the donor's adjusted gross income is allowable as a carryover in each of the five succeeding taxable years in order of time. Code §170(b)(1)(C)(ii). In the case of corporate donors, charitable deductions are always limited to 10% of the corporation's taxable income, computed with certain adjustments, regardless of the type of the donee or the type of the contribution. Code §170(h)(2). The amount of the contribution in excess of 10% of the corporation's taxable income is allowable as a carryover in each of the five succeeding taxable years in order of time. Code §170(d)(2)(A).

### III. Substantiation

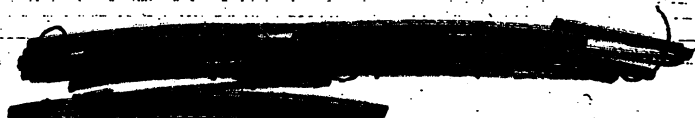
If all or part of the donor's dual payment consists of property other than cash, the donor must obtain a qualified appraisal of such property within 60 days prior to closing to determine the fair market value of the property and thus the amount of the premium. See Treas. Reg. §1.170A-13(c)(3). The appraisal should include the following: (1) a description of the property being sold; (2) the date of the appraisal and the closing; (3) the terms of the transfer; (4) the name, address and federal identification number of the qualified appraiser; (5) the qualifications of the qualified appraisal; (6) a statement that the appraisal was prepared for income tax purposes; (7) the appraised fair market value of the property; (8) the method of valuation used; and (9) the specific basis for the valuation, such as specific comparable sales

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transactions. Treas. Reg. §1.170A-13(c)(3)(ii). While the appraisal is required to state the fair market value of the property, it is not necessary for the appraisal to state the value of the premium payment.

If you have any questions or would like to discuss these issues further, please give me a call.

Sincerely,

A large, thick black horizontal bar redacting the signature and name of the sender.

# CHOATE, HALL & STEWART

## MEMORANDUM

To: Hans P. Birle, Esq.  
cc: [REDACTED] Esq.  
From: [REDACTED]  
Date: October 18, 2001  
Re: Status of Negotiations with Herring Creek Acquisition Company Regarding "Tax Make-Whole Payment"

The basic deal between The Nature Conservancy ("TNC") and Herring Creek Acquisition Company ("HCAC") is that TNC will cover any tax liability incurred by HCAC as a result of TNC's having conveyed Lots 2 and 3, Blue Heron and Sanderling (collectively, the "Conveyed Lots") to HCAC for no consideration, but subject to the further agreement that TNC will receive a credit against the "tax make-whole payment" (the "TMW Payment") to reflect the charitable deductions that HCAC will be able to pass through to its members based upon HCAC having made a bargain sale gift to TNC (the "Bargain Sale Gift") of some portion of the "preemptive rights" under the so-called 1969 Agreement. Currently, there is a \$3,299,000 (plus some amount of accrued interest) escrow account (of which D. [REDACTED] of Nutter, McClennan & Fish and I are the co-escrow agents) to cover the TMW Payment.

### Calculation of TMW Payments Prior to Giving Any Effect To Bargain Sale Gift.

HCAC and TNC have agreed that (a) the federal tax component of the TMW Payment will be calculated by multiplying the fair market value ("FMV") of the Conveyed Lots by .2 and then dividing that product by .8 and (b) the state tax component of the TMW Payments will be calculated by multiplying the FMV of the Conveyed Lots by .05 and then dividing that product by .95. [REDACTED] of Meredith & Grew provided a real estate appraisal which states that the FMV of the Conveyed Lots is \$6,375,000. Using this FMV and the agreed upon formula, the TMW Payment before giving any effect to the Bargain Sale Gift would be as follows:

Federal Component:  $\$6,375,000 \times .2 \div .8 =$  1,593,750.00

State Component:  $\$6,375,000 \times .05 \div .95 =$  335,526.00

Total TMW Payment: 1,929,276.00

Status of Negotiations with Herring Creek Acquisition Company Regarding Tax "Make-Whole-Payments"

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Calculation Of Bargain Sale Gift

The first step in establishing the Bargain Sale Gift is establishing an FMV for the "preemptive rights". [REDACTED] has appraised the "preemptive rights" at \$14,000,000 and a second appraiser, [REDACTED] (Appraisal/Economics, Inc. in Chicago, Illinois) has also concluded that the "preemptive rights" are worth at least \$14,000,000 (although [REDACTED] employed a dramatically different methodology for his valuation than did [REDACTED] who established that value on more or less a real estate appraisal analysis). HCAC has indicated that it is willing to agree that the "preemptive rights" have a value of \$14,000,000. Thus, the Bargain Sale Gift will equal \$14,000,000 minus the total consideration received by HCAC from TNC in connection with TNC's acquisition of the "preemptive rights". After a fair amount of debate and discussion between [REDACTED] and I on behalf of TNC and [REDACTED] and [REDACTED] on behalf of HCAC, the current positions of the respective parties regarding the calculation of the Bargain Sale Gift are set forth on the attached Chart 1.

The Bargain Sale Gift amount in the TNC column on Chart 1 will obviously increase as the TMW Payment is decreased to reflect the credit for the Bargain Sale Gift (although my algebra skills are far too limited to include any detail in this memo as to exactly how the variable for the TMW Payment and the variable for the Bargain Sale Gift figure are finally brought into equipoise with one another). Based on the current statements made by [REDACTED] and [REDACTED], they and HCAC have determined that the Bargain Sale Gift amount is more or less \$1,000,000 and so it would appear that [REDACTED] and [REDACTED] would simply adjust one of the other items in the HCAC column on Chart 1 (most likely the "enhancement" value item) to offset any reduction in the TMW Payment line item so as to maintain a bottom line Bargain Sale Gift calculation of roughly \$1,000,000.

Applying Credit For Bargain Sale Gift To The TMW Payment

There also seems to be some disagreement between TNC and HCAC as to how the credit for the Bargain Sale Gift is reflected in the TMW Payment. TNC takes the position that the total amount of the Bargain Sale Gift should be deducted from the FMV for the Conveyed Lots prior to calculating the federal tax component of the TMW Payment. The reference in the Agreement between TNC and HCAC that the tax savings for the gift would be "calculated on the basis of a presumed federal tax rate of 20%" was meant to show that the tax savings would be deemed to parallel the capital gain rate of 20% that would be applied to the overall transaction as a capital transaction (and would not be based on the actual tax savings to those members of HCAC who would be using their share of the charitable deduction against income that was taxed at a rate significantly higher than 20%). Since there is no charitable deduction available against state income taxes in Massachusetts (and it was the Massachusetts capital gain rate that was used to calculate the state component of the TMW Payment), there was no corresponding credit to the state component of the TMW Payment calculation. HCAC contends that the credit for the Bargain Sale Gift should simply be 20% of the Bargain Sale Gift amount and nothing more; that is, there should be no "gross-up" for the savings even though the credit is being applied against a "grossed-up" tax payment on the other side of the equation. The net result of HCAC's position

Status of Negotiations with Herring Creek Acquisition Company Regarding Tax "Make-Whole-  
Payments"

Memorandum

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is that TNC only gets a \$20,000 credit for each \$100,000 of Bargain Sale Gift even though TNC made a federal component TMW Payment of \$25,000 per \$100,000 of FMV for the Conveyed Lots. The logic of this position totally escapes me, but this nevertheless seems to be what [REDACTED] and [REDACTED] are saying.

Conclusion

Based on all of the foregoing, TNC would say that the TMW Payment should be approximate \$1,400,000 as shown in the TNC calculations set forth on the attached Chart 2 and HCAC would say that the TMW Payment should be approximately \$1,730,000 as shown in the HCAC calculations set forth on the attached Chart 2.

# CHART 1 - BARGAIN SALE GIFT CALCULATION

## TNC

## HCAC

	\$14,000,000		\$14,000,000
minus	\$6,375,000 (FMV of Conveyed Lots)	minus	\$375,000 (FMV of Conveyed Lots)
minus	\$1,700,000 (cash payment to HCAC)	minus	\$1,700,000 (cash payment to HCAC)
minus	\$350,000 (HCAC legal fees to NMF)	minus	\$350,000 (HCAC legal fees to NMF)
minus	\$625,000 (value of Beach Rights given to existing [redacted] lots) (Note 1)	minus	\$1,250,000 (value of Beach Rights given to existing [redacted] lots) (Note 1)
minus	\$1,400,000 (value of release of preemptive rights encumbering existing [redacted] lots) (Note 2)	minus	\$500,000 (value of release of preemptive rights encumbering existing [redacted] lots) (Note 2)
minus	\$1,929,276 (TMW Payment) (Note 3)	minus	\$1,929,276 TMW Payment (Note 3)
minus	\$0 (enhancement to value of existing [redacted] lots) (Note 4)	minus	\$895,524 (enhancement to value of existing [redacted] lots) (Note 4)
	<u>\$1,620,724</u> Total Bargain Sale Gift		<u>\$1,000,000</u> Total Bargain Sale Gift

Note 1: HCAC thinks that the Beach Rights are worth \$250,000 per lot because the [redacted] planned to sell beach rights at their proposed beach club for \$250,000 a piece. Since the Beach Rights received by the [redacted] lots can only be sold in conjunction with a sale of the relevant lot, the rights should be valued at lesser amount and so I have discounted the value of beach rights by 50% (although we have no formal real estate appraisal to this effect).

Note 2: The [redacted] land that was subject to the preemptive rights had acreage equal to roughly 10% of the acreage of the [redacted] land that was subject to preemptive rights; therefore, the \$1,400,000 figure simple represents 10% of [redacted] conclusion that the preemptive rights encumbering the Wallace land were worth \$14,000,000. For some reason, HCAC has indicated that this item should only be ascribed \$500,000 in value but without any real explanation as to why.

Note 3: This figure does not reflect reduction for the credit that will be generated by giving effect to the Bargain Sale Gift. See Chart 2 for my rough cut at how this credit will ultimately reduce the TMW Payment to \$1,400,000+.

Note 4: This item seems to be the major source of discrepancy between the TNC approach and the HCAC approach. If there is any enhancement value to be considered, it should simply be the enhancement that HCAC achieved by refusing [redacted]'s six lot development proposal (which TNC had tentatively approved) and insisting that the six new houses to be reduced to four new houses. It is not the enhancement value achieved by reducing a 33 lot subdivision to only four new houses. Moreover, there is a very strong argument to be made that the enhancement does not need to be considered in any respect; to the extent it is factored in, it creates a taxable event for HCAC and so it is difficult to understand why HCAC is pressing this point so aggressively. The \$895,524 is simply my "plug" number to yield the \$1M figure that [redacted] and [redacted] stated to be HCAC's estimate of the Bargain Sale Gift amount.

## CHART 2

### CALCULATION OF TMW PAYMENT

#### TNC Calculation

Federal Component of TMW Payment: $(6,375,000 - 1,620,722) \times .2 \div .8 = 1,188,569.50$	Federal Portion of TMW Payment: $6,375,000 \times .2 \div .8 =$	1,593,750.00
State Component of TMW Payment: $6,375,000 \times .05 \div .95 =$	State Portion of TMW Payment: $6,375,000 \times .05 \div .95 =$	335,526.31
	TOTAL TMW Payment Prior To Credit minus	<u>\$1,929,276.31</u>
TOTAL TMW Payment (Note 1)	Credit for Bargain Sale Gift: $\$1,000,000 \times .2 =$	\$200,000.00
	NET TMW Payment:	<u>\$1,729,276.31</u>

Note 1: Based on my very rough efforts to further refine the TMW Payment to reflect the increased Bargain Sale Gift which in turn generates a lower TMW Payment, it appears to me that the final TMW Payment should settle in at roughly \$1,350,000 to \$1,400,000; so the real amount in controversy between the TNC position and the HCAC position is approximately \$330,000 to \$350,000.

3325318v1

**Deloitte &  
Touche**



Post-it* Fax No e	7671	Date	5/31/00	# of pages	7
To	[REDACTED]	From	[REDACTED]		
Co./Dept.	TNC	Co.	TNC		
Phone #		Phone #			
Fax #	303 541-0346	Fax #	208 522-4944		

**Deloitte & Touche LLP**  
National Tax  
555 12th St., NW, Suite 500  
Washington, DC 20004

Telephone: 202-879-5305  
Facsimile:  
www.us.deloitte.com

To:	Company/Office:
[REDACTED]	The Nature Conservancy - Eastern Idaho Office
Fax Number:	Phone Number:
208-522-4944	208-522-4350
From:	Office:
[REDACTED]	Washington DC
Fax Number:	Number of Pages (including this one):
202-661-1251	11
Date:	To confirm receipt, or if you do not receive all pages, please call:
May 19, 2000	202-879-4996
Comments:	

Following is our draft memo. We have sent it in draft to ensure we have answered the questions you requested. Please call me at (202) 879-4996 with any questions or comments.

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**Deloitte &  
Touche**



## Memo

**Deloitte & Touche LLP**  
National Tax  
555 12th St., NW Suite 500  
Washington, DC 20004

Telephone: 202-879-5300  
Facsimile:  
www.us.deloitte.com

Date: May 15, 2000  
To: Allen May  
The Nature Conservancy, Eastern Idaho Office  
From: [REDACTED]  
Subject: Diamond D Corporation Questions

**DRAFT**

*The purpose of this memorandum is to respond, in general terms, to the questions posed in your fax dated May 2, 2000, as they pertain to the tax implications of the conversion of Double D Corporation to a Subchapter S Corporation ("S Corp.") and the subsequent grant of a qualified conservation easement.*

*This memorandum is a confidential communication between Deloitte and Touche LLP ("D&T") and The Nature Conservancy and is not to be relied on by, or exhibited to, third parties without the express written consent of D&T. The discussion of the issues and recommendations contained in the memorandum are based on the facts and assumptions set forth herein, and the published authorities as of the date of this correspondence. D&T assumes no obligation to update the memorandum for any future changes in tax law, regulations, or other interpretations. The effect of this arrangement under any state or federal law other than as specifically stated herein is beyond the scope of this memorandum.*

*The memorandum is a general discussion of concepts and is not intended to be an opinion of income tax consequences regarding any particular transaction. In addition, this memorandum will not address the federal or state income tax implications of any specific transaction to either the shareholders of Double D nor to The Nature Conservancy. Should a specific transaction be contemplated, the information discussed herein should be evaluated in light of the transaction and we will offer advice or opinions based on the documentation of the transaction as represented at that time.*

*Scenario for donated  
easement?  
what amt of gift would  
flow to individual?*

**Deloitte & Touche**  
MEMORANDUM

Diamond D Corporation Questions

**DRAFT**

2

During our May 2, 2000, conference call, we discussed various strategies for using tax savings to accomplish the goal of protecting land owned by Double D Corporation. Two families, the [redacted] and the [redacted] presently own the Double D Corporation. The Nature Conservancy ("TNC") indicated that initially the Irvings wanted to contribute a conservation easement as part of an overall plan to transfer their ownership to the [redacted]. As indicated, the intent was to carry out this purpose through a part sale/part gift to the TNC followed by the TNC's sale of Double D stock to the [redacted]. *the stock*

However, as discussed, because the land is held by Double D, the individual shareholders cannot claim a charitable contribution deduction on their personal returns for the contribution of the easement to TNC by the corporation. Thus, neither the [redacted] nor the [redacted] would obtain any economic benefit from a charitable contribution deduction resulting from a gift of the conservation easement. Any benefit from the gift of the easement would be trapped in Double D, which is not expected to produce sufficient income to fully utilize the deduction.

During our discussions we identified a possible alternative structure whereby ownership could be transferred between the two families, without intervention of TNC. The 100% successor owners, the [redacted], could then elect subchapter S status for the corporation, and through the S Corp donate or sell an easement to TNC. If there is a charitable contribution of the easement it would then "flow-through" to the shareholders for deduction on their individual tax returns, subject to limits outlined in IRC §170.

**Questions Posed by The Nature Conservancy**

1. What are the issues surrounding the election of Subchapter S status?
2. Would the grant of a qualified conservation easement trigger corporate level tax on "built in gain" of the Subchapter S Corp assets?
3. What are the issues surrounding the bargain sale of an easement to TNC by the [redacted] once they have elected Subchapter S status for Double D?
4. What is the required holding period of the S Corp prior to donating a conservation easement to The Nature Conservancy?
5. What are the implications on the shareholder's ability to deduct the charitable contribution on their personal returns (after electing Subchapter S status) if The Nature Conservancy pays a small amount (i.e. bargain sale) for the easement?
6. Can the shareholders take advantage of the IRC §2031(c) exclusion for estate tax purposes?

Diamond D Corporation Questions

3

**DRAFT**

**Relevant Tax Law & Discussion**

*1. Election of Subchapter S Status*

Assuming that the alternate plan suggested by D&T is followed and that the [REDACTED] sell their Double D Corporation stock to the [REDACTED], you have inquired as to what the consequences would be of the S [REDACTED] converting the Double D Corporation to an S Corp.

A corporation must meet the requirements of several statutory provisions and elect to be treated as an S Corp. We have attached the federal Form 2553 and the instructions for your review which detail the process and the requirements for electing Subchapter S status. However, we wish to again point out that we are not offering advice on the [REDACTED] family's need or ability to elect Subchapter S status. The discussion which follows accordingly is predicated on the [REDACTED]'s ability to choose to elect Subchapter S status.

Upon election of Subchapter S status, the assets held by a C corporation are subject to the "built-in gains" ("BIG") tax rules of IRC §1374. Under these rules, corporate level tax may apply irrespective of the basic S Corp rules dictating tax at the shareholder level only under certain circumstances. Essentially, IRC §1374 requires that any appreciation in the C Corporation that has not previously been taxed may be taxed at some point if a "triggering event" occurs during the 10-year period following the date of conversion. This tax is only triggered upon the disposition of an asset or the recognition of a built-in gain item within a 10-year period from the date of the election. Each year there are two limitations to taxing the BIG at the corporate level which are (1) the total net unrealized built-in gain at the time of the S conversion and (2) the total taxable income of the current period.

Generally, we recommend obtaining an appraisal to "fix" the value of any assets held by the corporation at the time of the election, thereby "locking in" the amount of net built-in gain which is potentially subject to the BIG tax (subsequent appreciation may not be subject to the BIG tax). If no appraisal is obtained, it may be very difficult to substantiate the value of those assets on the date of conversion at the point in the future when the assets are subsequently sold or upon audit.

*2. Granting of an Easement as a "Triggering Event"*

In general, nontaxable transactions, such as the charitable gift or an easement on built-in gain property, do not constitute a recognition event for triggering the BIG tax, though a part sale/part gift would.

*3. Implications of a Bargain Sale of an Easement*

As noted above, should TNC purchase a conservation easement from Double D Corporation (now an S Corp) in a bargain sale, a pro-rated amount of the built-in gain would be triggered. (Note - all assets of the corporation are valued, at the time of conversion, to ascertain the maximum taxable amount of built-in gain the corporation may be required to pay tax on, however, here we are assuming that the gain on the sale of the land does not exceed this limitation and that there is no debt attached to the land) Assume the following:

Diamond D Corporation Questions

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the assets acquired prior to electing Subchapter S status carries over to the newly elected S Corp pursuant to IRC §1223. In other words, if the land was held for longer than 12 months by Double D, any gain or loss recognized upon the sale would be long-term capital gain. As it has been represented that the land has been held by the corporation in excess of 12 months, the reduction in the charitable contribution under IRC §170(e) is not applicable, and there is no "waiting period" required once Subchapter S status has been elected for the donation and/or bargain sale of the easement to occur.

*4. Ability of Individual to Utilize Charitable Contribution Deduction*

Each individual's ability to utilize the charitable contribution passed through from the S Corp will be dependent upon their personal income tax position and their basis in their S Corp interest. A shareholder of an S Corp is limited in the amount of losses and deductions available to be taken on their personal tax returns to their adjusted basis in the S Corp and any indebtedness of the S Corp to the shareholder.

In this regard, the S Corp shareholders (presumably, members of the ~~Stacy~~ family) should each seek counsel as to the consequences of the proposed transaction on their individual tax situations.

*5. Availability of IRC §2031(c) Exclusion from Gross Estate*

Under IRC §2031(a) the value of the gross estate of a decedent includes the value at the time of their death all property, real or personal, tangible or intangible, wherever situated. The Taxpayer Relief Act of 1997 added IRC §2031(c) which provides that an executor of an estate, upon making an election, can exclude the lesser of the applicable percentage of the value of land subject to a qualified conservation easement, reduced by the amount of any charitable deduction that was taken by the estate with respect to such land under IRC §2055(f), or the "exclusion limitation". Applicable percentage is defined as 40% reduced by 2 percent for each point by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without the easement but reduced for retained development rights).

This exclusion is available for land which was either encumbered during the lifetime of the decedent or upon death through operation of a will or other means.

This exclusion is applicable for decedents dying after December 31, 1997, and is limited to \$500,000 for the year 2002 and after. For decedents dying prior to 2002 there is a table provided in the statute which phases in the exclusion.<sup>1</sup>

In addition, it appears that the exclusion is available for interests held through a partnership, corporation or trust if at least 30% of the entity is owned (directly or indirectly) by the decedent in accordance with the attribution rules found in IRC §2057(e)(3), which essentially means the decedent or the decedent's family must own 30% of the partnership, corporation or trust.

It is important to note that IRC §2031(c) delineates the requirements that land subject to a

<sup>1</sup> This exclusion is in addition to the qualified family owned business deduction provided under IRC §2057.

Diamond D Corporation Questions

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FMV of land at date of S election	\$	1,000,000
Basis to the corporation (inside basis)		<u>250,000</u>
Appreciation potentially subject to BIG		<u><u>750,000</u></u>

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FMV of land at time of granting of easement	1,000,000
FMV of land with easement in place	<u>800,000</u>
Easement fair market value	<u><u>200,000</u></u>
Purchase Price of easement	25,000

Under the part sale/part gift rules found in IRC §1011 and the regulations thereunder, upon the granting of an easement for less than its fair market value, the S Corp would be required to allocate basis to the easement in a proportion equal to the fair market value of the easement over the fair market value of the land unencumbered. In this instance the easement's basis would be \$50,000  $((\$200,000/1,000,000)*250,000)$ . However, since this would be a bargain sale, the basis needs to be further allocated between the sale portion and the gift portion of the conservation easement. The basis allocated to the sale portion would be \$6,250  $((\$25,000/200,000)*\$50,000)$ .

The remainder basis of \$43,750 would be allocated to the charitable contribution portion of the bargain sale.

Based on the foregoing, the gain from the sale portion at the corporation level would be \$18,750  $(\$25,000 - \$6,250)$ , which could potentially be subject to the BIG tax currently. The contribution portion would not be taxed, as a charitable contribution is not a triggering event for the BIG tax. However, the amount of the charitable contribution, which would flow through to the shareholders based upon ownership percentage, would be \$175,000.

The end result is that the entire <sup>(reduced)</sup> \$18,750 gain may be subject to tax at the corporate level, subject to certain limitations discussed above, and an amount equal to the \$18,750 gain (net of the tax paid) at the corporate level would also be subject to tax at the shareholder level (i.e. since the S Corp is a "flow-through" entity).

Assuming the entire amount of BIG is taxable, the tax paid by the corporation would be \$6,562.50  $(35\% * \$18,750)$ . As a side note, if the Corporation has a net operating loss carryforward or a capital loss carryforward, these amounts may be used to offset the built-in gain recognized at the corporate level. Also, keep in mind that any built-in gain recognized, net of the corporate level tax paid, is also taxed at the individual level when it is passed through to the shareholders on their Schedule K-1s. The charitable contribution of \$175,000 would also be passed through to the shareholders based upon their ownership percentage.

3. Required Holding Period

There is an additional limitation under IRC §170(e) which requires that the charitable contribution deduction be reduced for any amount of gain which would not have been long term capital gain had the property in question been sold. Short term or long-term gain or loss characterization is based upon the length of time the asset has been held. The holding period of

Diamond D Corporation Questions

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conservation easement must meet in order to qualify for the exclusion. The encumbered land will qualify if it is located--

- a) in or within 25 miles of an area which, on the date of the decedent's death, is a metropolitan area (defined by the Office of Management and Budget),
- b) in or within 25 miles of an area which, on the date of the decedent's death is a national park or wilderness area designated as part of the National Wilderness Preservation System (unless it is determined by the Secretary that land in or within 25 miles of such a park or wilderness area is not under significant development pressure), or
- c) in or within 10 miles of an area which, on the date of the decedent's death, is an Urban National Forest (as designated by the Forest Service),
- d) which is owned by the decedent or a member of the decedent's family at all times during the 3-year period ending on the date of the decedent's death, and
- e) with respect to which a qualified conservation easement has been made by an eligible individual pursuant to the provisions of this section.

Note that the aforementioned requirements apply to the exclusion (only) and not to the deduction. Whether or not the land held by the Double D Corporation meets the above definition or whether this would apply to the ~~Double D Corporation~~ would have to be evaluated by an appropriate party, and we are not currently making that determination for TNC. The conservation easement must be "qualified" as defined in IRC §170(h)(1), which defines a qualified conservation easement for charitable contribution purposes. In addition, if there are rights retained by the grantor of the easement, there would be implications on the valuation of the exclusion as well as the valuation and qualification of the easement for charitable contribution purposes.

It should be noted that the Treasury Department has not issued regulations to assist taxpayers in the application of the exclusion provisions. Our discussion above is limited to the statutory language enacted as IRC §2031(c).

May \_\_, 2001

The Forest Bank, LLC  
c/o The Nature Conservancy  
339 East Avenue, Suite 300  
Rochester, NY 14604

**The Forest Bank, LLC**  
**U.S. Federal Income Tax Opinion**

Ladies and Gentleman:

We have acted as counsel to The Forest Bank, LLC, a Delaware limited liability company (the "Company"), in connection with the preparation of an S-1 registration statement filed on March 2, 2001 (the "Registration Statement") and the offering and sale (the "Offering") pursuant to the Prospectus contained as part of the Registration Statement (the "Prospectus") of 15,000,000 Preferred Units of the Company. The Company is governed by the Amended and Restated Limited Liability Company Agreement of the Company, dated as of May \_\_, 2001 (the "LLC Agreement"), by and among The Nature Conservancy, a District of Columbia nonprofit organization ("TNC"), and other persons who are record owners of membership units in the Company (as identified in the LLC Agreement). Capitalized terms used herein have the same meanings as ascribed to them in the LLC Agreement. You have requested our opinion regarding certain U.S. federal income tax matters in connection with the Offering.

In giving the opinions set forth below, we have reviewed original or copies of the following:

1. the LLC Agreement, including the exhibits thereto;
2. the private letter ruling addressed to TNC from the Internal Revenue Service, dated July 20, 2000, with respect to the Company (the "Private Letter Ruling");
3. the forms of the Nature Conservancy Conservation Easement, the Forest Bank Management Easement, and the Forest Bank Management and Conservation Easement;
4. the Subscription Agreement;

The Forest Bank, LLC  
May \_\_, 2001  
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5. the Management Agreement; and
6. the Prospectus.

We also have reviewed such other records, documents and matters of fact and law as we have deemed necessary or relevant for purposes of rendering the opinions expressed below. In addition, we have assumed, with your permission, the authenticity of all documents submitted to us as originals, the conformity to the originals of all documents submitted to us as certified or photostatic copies and the authenticity of the originals of such copies, the genuineness of signatures not witnessed by us, the legal capacity of natural persons, and the due authorization, execution, and delivery of all documents by all parties thereto and the validity, binding effect, and enforceability thereof.

Furthermore, we have assumed, with your permission, the following:

1. the transactions contemplated by the Prospectus will be consummated in accordance with the descriptions in the Prospectus;
2. all of the terms and conditions of the LLC Agreement and other governing documents will be satisfied;
3. no Preferred Member will exercise his or her redemption rights within two years of the contribution of the Timber Rights to the Company;
4. the Company will not assume the liabilities of any Member or take Timber Rights subject to any indebtedness;
5. prior to the contribution of Timber Rights to the Company, each Preferred Member will have held his or her Timber Rights for at least one year and no Preferred Member will have held his or her Timber Rights as inventory primarily for sale to customers in the ordinary course of his or her trade or business; and
6. except for the LLC Agreement, the Nature Conservancy Conservation Easement, the Forest Bank Management Easement, the Forest Bank Management and Conservation

The Forest Bank, LLC

May \_\_, 2001

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Easement, the Subscription Agreement, and the certificates attached as exhibits to or otherwise described in the Prospectus, there are no agreements or understandings, express or implied, between the Company or TNC, on the one hand, and any of the Members, on the other hand.

Finally, we are relying upon the conclusions of the Internal Revenue Service set forth in the Private Letter Ruling.

Our opinions are based upon the current provisions of the Internal Revenue Code of 1986, as amended (the "Code"), the Treasury regulations promulgated thereunder, current administrative rulings, judicial decisions, and other applicable authorities, all as in effect on the date hereof. All of the foregoing authorities are subject to change or new interpretation, both prospectively and retroactively, and such changes or interpretation, as well as any changes in the facts as they have been represented to us or assumed by us, could support a position contrary to our opinions expressed below or could otherwise affect our conclusions. Our opinion does not foreclose the possibility of a contrary determination by the Internal Revenue Service or by a court of competent jurisdiction, or of a contrary position by the Internal Revenue Service or the Treasury Department in regulations or rulings issued in the future.

Based upon all of the foregoing and subject to the qualifications stated herein, we are of the opinion that:

- (a) the Company will be classified as a partnership for federal income tax purposes;
- (b) each Member will be treated as a partner of the Company for federal income tax purposes;
- (c) no gain or loss will be recognized by a Preferred Member upon the contribution of his or her Timber Rights to the Company in exchange for Preferred Units;
- (d) any gain recognized by the Company for federal income tax purposes from the Company's harvesting activities pursuant to the Forest Bank Management Easements

The Forest Bank, LLC

May \_\_, 2001

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and the Forest Bank Management and Conservation Easements will be treated as long-term capital gain;

(e) for federal income tax purposes, the allocations of income, gain, loss, deduction, and credit in the LLC Agreement should have substantial economic effect or otherwise be respected under Code sections 704(b) and 704(c) and the Treasury regulations thereunder; and

(f) the descriptions of the law contained in the Prospectus under the caption "Federal Income Tax Considerations" are correct in all material respects, and the discussions thereunder fairly summarize the U.S. federal income tax considerations that are likely to be material to a Preferred Member.

We hereby consent to the filing of this opinion as an exhibit to the Registration Statement. In giving this consent, we do not admit that we are in the category of persons whose consent is required by Section 7 of the Securities Act of 1933, as amended, or the rules and regulations promulgated thereunder by the Securities and Exchange Commission.

The foregoing opinions are limited to the U.S. federal income tax matters addressed herein, and no other opinions are rendered with respect to other federal tax matters or to any issues arising under the tax laws of any other country, or any state or locality. We undertake no obligation to update the opinions expressed herein after the date of this letter. This opinion letter is solely for the information and use of the addressee and the holders of Preferred Units, and it may not be distributed, relied upon for any purpose by any other person, quoted in whole or in part or otherwise reproduced in any document, or filed with any governmental agency without our express written consent.

Very truly yours,

03352/07796/01655

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May \_\_, 2001  
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Path: [REDACTED] 05-01.DOC  
Doc #: 657278; V. 3  
Doc Name: H&W Tax Opinion  
Author: Van [REDACTED]  
Typist: Van [REDACTED]  
Last Edit: 5/1/01 4:04 PM



In response to SFC #2  
question l.d.

3-19-04  
JUN 14 1995

Big Hole River  
(Arrow Land & Livestock, Inc.) MT

ROBERT M. KNIGHT  
JAMES J. MASAR  
ANDREW C. DANA

June 13, 1995

Mr. Hugh Zackheim  
The Nature Conservancy  
Big Sky Field Office  
32 South Ewing  
Helena, MT 59601

RE: Arrow Ranch Conservation Easement

Dear Hugh:

As promised last week, we enclose our proposed changes your first review draft of the Arrow Ranch Conservation Easement. Consistent with our normal practice, you will find two versions of the Conservation Easement: (1) a "Redline" draft with all additions and deletions shown in highlighted and strikeout typefaces, and (2) a "clean" version of the easement which incorporates all of our proposed changes. We have also enclosed a computer disk with the two versions encoded in Wordperfect 5.1 format.

Our proposed changes are extensive, and, for the most part, are explained in detail below. The reasons for the changes that are not discussed in this letter should be self-evident, but, if they are not, please call and we will explain the reasons for the proposed modifications. The ~~owners~~ have reviewed this version of the Conservation Easement and approve of it in its current form.

Apart from the specific modifications discussed in this letter and reflected on the "Redline" version of the Conservation Easement, you should be aware that the ~~owners~~ are still considering whether they wish to claim a charitable income tax deduction for their gift to the Conservancy. Depending on their decision, they may choose not to acquire the outstanding mineral estate on the Ranch. In this circumstance, the Conservancy may wish to commission an independent study of the mineral development potential of the property. Furthermore, if the ~~owners~~ decide not to claim an income tax deduction, additional changes to the Conservation Easement may be made to excise portions that are currently driven by the requirements of the federal tax code and Treasury Regulations.

Turning to the specific changes we recommend, we refer below to the pages of the enclosed "Redline" draft upon which the modification appear.

Mr. Hugh Zackheim  
June 13, 1995  
Page 2

✓ Pages 1-2: The Conservation Easement will be granted by [REDACTED] & [REDACTED], Inc., not the [REDACTED] individually. We also believe it is important to clarify certain factual representations included in the Recitals: (a) that the Ranch does not incorporate any portion of the Big Hole River per se; (b) that the main body of the ranch does not lie within one mile of the Anaconda-Pintlar Wilderness; and (c) that although the "region" may be undergoing increasing development, the Big Hole Valley itself is not under severe development pressure.

✓ Pages 3-4: We have heavily edited the initial statement of purposes of the conservation easement. In making these modifications, we have attempted to clarify the terms of the conservation easement by eliminating ambiguous and indefinite terms. For example, we believe that it is more appropriate for the conservation easement to protect natural "resources" rather than natural "values", because values are highly subjective. (We have made this change throughout the conservation easement document, as appropriate.) We have also tried to eliminate words that are not capable of easy definition (e.g., what is watershed "integrity", or "significant impairment" of a resource?).

✓ Pages 4-5: We have amended the easement to reflect that the baseline report will be recorded, along with the signed acknowledgement that the property condition is accurately described within the baseline report. We believe that recording baseline reports adds clarity to the purposes of the conservation easement. Furthermore, we have inserted a provision into the conservation easement that if the baseline report conflicts with the conservation easement in any manner, the express language in the conservation easement governs. Similar language should be included in the baseline report itself.

✓ Pages 6-8: At pages 6-8 of the conservation easement, we have made extensive modifications to provisions concerning improvements on the property, as directed by the [REDACTED]. First, we attempt to group facilities by usage and/or location, and we have rearranged the subsections of Paragraph A accordingly.

Second, we have deleted the reference to "single-family" residences to avoid any conflicts that might arise over the meaning of this term.

Third, we have deleted references to "seasonal or short-term" use of other housing facilities on the property, in anticipation that the [REDACTED] might use the Arrow Ranch as a research and educational facility, either of which might sponsor long-term research projects requiring habitation of the ranch buildings for relatively long periods of time.

Fourth, the [REDACTED] wish to reserve the right to renovate the barn at the [REDACTED] site for use in conjunction with a small horse ranch, so we have modified the conservation easement to allow this activity and to permit expansion of the barn by 25% of the current gross square footage.

Mr. Hugh Zackheim  
June 13, 1995  
Page 3

Finally, we have inserted a provision allowing the [REDACTED] to renovate and upgrade an existing cabin near the Forest Service boundary, and we have reserved a right to allow the Buchers to construct four additional cabins. We need to consult further with the Buchers about where they would like to permit future cabin construction. As noted in the Easement, an Exhibit "F" will disclose the existing cabinsite and the reserved cabinsite locations, assuming they can be selected in advance. If the [REDACTED] cannot decide on the location for these cabins, we will modify the easement to leave cabinsite location unresolved and subject to later designation.

The [REDACTED] want to place specific limitations on the use of these cabins. Therefore, we have provided that the cabins may only be used as temporary lodging for permitted recreational purposes or in conjunction with other activities that are allowed by the easement.

✓ Page 8: We have modified the reserved right to construct roads on the property so that new roads may be constructed as such roads "are reasonably necessary" to [REDACTED]'s ability to engage in authorized uses of the property. We have specifically provided a right to construct roads to provide vehicular access to all improvement and structures on the Ranch.

✓ Pages 8-9: The affirmative obligation placed on the [REDACTED] in the draft easement that they "shall work cooperatively with the Conservancy" to develop a Range Recovery Plan if range condition deteriorates may become a flashpoint of disagreement between the Conservancy and any future owner of the Arrow Ranch who disagrees with the Conservancy's goals for range recovery. We have therefore eliminated the requirement. Range degradation is now governed by the general breach and remedy provisions.

Pages 9-10: Your suggested provisions on management and control of sagebrush appear to alter in subtle ways many of the prior approval provisions contained in Section V. We believe the goals of consistency and enforceability are better served if Section V governs virtually all prior approval provisions and have made changes to this effect throughout the easement. Please note that the Buchers have approved of the concept of annual and ten-year limitations on the number of acres of sagebrush that may be treated. We would appreciate your input in what the appropriate numbers should be. The [REDACTED] are checking with their ranch manager.

NB - We have also preserved the [REDACTED]' right to harvest hay, grain and other crops in areas that have historically been used for such purposes and in areas that will be designated prior to finalizing the conservation easement. These areas will need to be negotiated with the [REDACTED] and designated in the Baseline Report.

Mr. Hugh Zackheim  
June 13, 1995  
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✓ Pages 10-11: We found the water development provisions in your review draft somewhat confusing. On the one hand, they permit development of water resources, but on the other hand, they prohibit "significant or long-term impairment of water quality, aquatic ecology or riparian values." These provisions seem to be internally contradictory: Almost any surface water development for domestic or irrigation purposes may ultimately harm aquatic and riparian values.

We have therefore tried to clarify the [REDACTED]'s rights to develop water on the property consistent with the uses permitted by the conservation easement. The [REDACTED]'s rights to develop water are limited, however, by Section VI, Paragraph M, of the conservation easement. Except for water developments necessary to engage in reserved rights under the conservation easement, the [REDACTED] may not drain or alter natural wetlands or water courses without Conservancy approval, and they may not cause any measurable degradation of surface or subsurface water quality. At the [REDACTED]'s request, we have also inserted a provision which prohibits long-term depletion of ground water reservoirs (pages 23-24).

We also believe that the simplest way to handle prior approval of stream improvement projects is to subject them to the prior approval provisions set forth in Section V.

✓ Pages 13, and 16-17: We have substantially expanded the [REDACTED]'s reserved rights to conduct scientific research on and to make educational use of the property (page 16). To ensure that this reservation does not swallow the conservation purposes of the easement, however, we have provided that all scientific and educational activities must be consistent with the purposes of the easement. Furthermore, we have inserted an express right allowing the [REDACTED] to "trap, band, and mark" wildlife species for scientific and educational purposes. We have also indicated that the [REDACTED] have the right to "trap and collect" limited numbers of native wildlife species, as long as they comply with State and federal law. Furthermore, any such activities cannot pose a threat to the long-term viability of wildlife populations both on the property and on adjacent lands.

✓ Pages 13-14: Although the stands of timber on the Arrow Ranch are not extensive, the [REDACTED] mentioned that some timber does grow on the property. We have therefore incorporated a provision in the conservation easement to govern timber harvest rights. We have attempted to outline specific goals of any permissible timber harvest, and we have specifically provided that a large scale timber harvest (as defined by mutual agreement between the parties prior to finalizing the conservation easement) requires advance approval of a timber harvest plan. If you believe that the Arrow Ranch timber base is so negligible that this provision should be further simplified, please let us know and we will try to work out changes.

NP

Mr. Hugh Zackheim  
June 13, 1995  
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✓ Page 15: We have also modified the provision of the conservation easement which permits the [REDACTED] to extract rock and gravel from designated sites on the property.

NE  
We have advised the [REDACTED] that inclusion of this provision may jeopardize their ability to claim a federal income tax deduction, in part, if the I.R.S. considers gravel to be a mineral and gravel extraction to be surface mining. Montana law is not clear on these matters. Therefore, we have advised the [REDACTED] to obtain tax advice on this issue. The [REDACTED] have also expressed some interest in simply deleting the sites of their gravel pits from the easement, if retention of the right to remove gravel from them causes problems with the I.R.S.

Of course, if the [REDACTED] decide not to claim a tax deduction, this whole problem may become moot.

✓ Page 16: In Subparagraph "Q", We propose that "wildlife habitat improvement" projects be submitted for the Conservancy's prior approval under Section V.

✓ Page 17: We have inserted a new subparagraph "W" which reserves and retains to the [REDACTED] all rights which are not expressly conveyed to the Conservancy.

✓ Pages 18-20: We have amended the conservation easement to shorten the time period to 30 days in which the Conservancy has to review any requests for prior approval. We believe that a 45-day review is unreasonable. Under your proposal, an action that the Grantor wishes to take may be delayed for up to three months, or longer, from the time prior approval is requested. We have attempted to reduce this time for review by at least one month. Furthermore, we have shortened the time in which the Conservancy must request additional information to 20 days, again in an attempt to speed up the prior approval process. Finally, we believe it is appropriate to require that the Conservancy to put in writing all reasons for denial of prior approval requests.

✓ Page 20-21: We suggest substantial changes to Section VI, Paragraph B, which concerns restriction on division of the property. We have inserted language to clarify that structures and improvements on the property may not be conveyed separately from legal title to the balance of the Ranch. On the other hand, we have also provided that a number of persons may own the Property in co-tenancy, with each co-tenant having an undivided interest in the whole of the property including the buildings. Furthermore, we have preserved the [REDACTED]' right to enter into lease agreements and similar arrangement, as long as all lessees and tenants abide by the terms of the conservation easement. None of these activities are to be considered subdivisions or "de facto" subdivisions.

✓ Page 23: In response to a concern about the [REDACTED]' ability to remove willows from irrigation ditches, we have modified Paragraph J in Section VI of the conservation

Mr. Hugh Zackheim

June 13, 1995

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easement to provide that they may remove native vegetation, specifically in conjunction with agricultural and ranching activities and other activities that are expressly permitted by Section IV of the conservation easement.

Page 24: We believe that Paragraph "N" in Section VI of your review draft may be overly restrictive concerning future uses of the property. We have attempted to expand the Grantor's permissible future uses, as long as such uses are conducted in harmony with the natural resources and values protected by the easement.

Pages 25-29: We have substantially rewritten the Remedies section of the conservation easement to streamline and clarify the respective rights of the parties. If there is an actual breach of the conservation easement, the Conservancy will have the right to serve a written demand on the Grantor to correct the breach. If the situation is not resolved within 30 days after Grantor's receipt of the notice of breach (or if Grantor does not continue to address the situation if it takes longer than 30 days to correct the problem), the Conservancy will have a right to bring an action in court to enforce the terms of the easement, to enjoin actions in violation of the easement, to recover damages that it may have suffered, and to require restoration of the property.

On the other hand, if the Conservancy determines that a breach has not yet occurred but is imminent, the Conservancy will have the right to enter the property to prohibit certain actions, and it will have the right to seek a temporary restraining order or preliminary injunction to prevent Grantor from taking actions which are likely to cause harm to the Conservancy's interests.

If a court ultimately determines that the Conservancy has no reasonable basis in law or fact for seeking a temporary restraining order or preliminary injunction, the Conservancy will be liable for all of the harm caused to the Grantor thereby, including costs and attorneys' fees. Furthermore, if there is ever litigation over actions permitted or prohibited by the conservation easement, the prevailing party will be entitled to fees and costs.

As requested by the ~~Board~~, we have inserted a representation from the Conservancy that it generally intends to enforce the terms of the conservation easement, notwithstanding the language which permits it to defer enforcement without penalty. We have also included a standard provision which will protect the Grantor from any liability for breach of the conservation easement as a result of causes beyond their control, such as fire, flood, drought, storm and earthquake, or actions taken under emergency conditions.

Pages 29-30: We have modified the Assignment section of the conservation easement to require the Conservancy to obtain the ~~Board's~~ prior consent to the assignment. The only time the Conservancy may assign this easement without the

Mr. Hugh Zackheim  
June 13, 1995  
Page 7

Grantor's prior consent is if The Nature Conservancy withdraws from Montana, or if the national office of The Nature Conservancy undergoes a corporate dissolution.

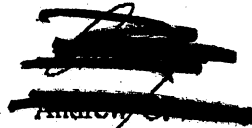
Pages 30-34 & Exhibit E: Section XI of the conservation easement concerning proceeds from involuntary conversions contains substantial revisions. We believe that our proposed language more accurately tracks the language and intent of the Treasury Regulations.

You will note that we also recommend attachment of an Exhibit "E" to the conservation easement. This exhibit is a form that we developed to memorialize the percentage by which the value of the property has been reduced through the grant of the conservation easement, and this percentage will be used in conjunction with the proceeds and condemnation section of the conservation easement, if necessary. Exhibit "E" appears on page 41 of the redline draft of the conservation easement.

We recognize that the changes we suggest are extensive and detailed. We hope that this letter will help to explain why we believe the changes are necessary and important. After you have had a chance to review and digest this letter and the enclosed materials, please do not hesitate to call if you have any questions, comments, observations, or matters which you believe need further clarification.

Sincerely,

KNIGHT & MASAR

  
Andrew C. [Redacted]

encls.

C. [Redacted] (w/enclosures)

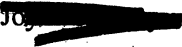
# Memo

**Deloitte  
& Touche**

*Metcalfscc. Rm - Pitchfork Ranch  
TNC*

Date: January 17, 2001

To: The Nature Conservancy

From: 

Subject: LIKE KIND EXCHANGES – SUMMARY OF TAX ISSUES

## INTRODUCTION

When a taxpayer exchanges an appreciated asset for another asset, the result under general income tax principles is that the taxpayer realizes gain. The amount of gain is equal to the difference between the fair market value of the property received and the taxpayer's tax basis in the property that was transferred. However, section 1031 of the Internal Revenue Code of 1986, as amended (the "Code") provides that taxpayers may exchange appreciated assets without recognizing gain or loss, provided that the exchanged properties qualify as "like kind" and certain other requirements are satisfied (a "1031 Exchange").

If a transfer of assets qualifies as a 1031 Exchange, then no gain or loss is recognized upon the transfer of those assets, rather the gain or loss is deferred. The assets received by the taxpayer in a 1031 Exchange are assigned a transferred tax basis, meaning that the tax basis of the property acquired is equal to the tax basis of the property transferred.<sup>1</sup> Thus, the potential gain or loss that is deferred as a result of the 1031 Exchange is preserved in the tax basis of the acquired assets.

Frequently, a 1031 Exchange will also involve transfers of cash or other non-like kind property ("boot"). A taxpayer who receives boot, as part of an exchange of properties that qualifies as a 1031 Exchange, may recognize gain with respect to all or a portion of the boot received.<sup>2</sup> Similarly, a 1031 Exchange may involve the transfer and/or receipt of property that is subject to liabilities. A taxpayer who transfers property subject to liabilities is treated as receiving cash in an amount equal to the liability that is transferred. Accordingly, the taxpayer may recognize a gain equal to all or a portion of the transferred liability. If both the assets received and the assets transferred in a 1031 Exchange are subject to liabilities, then the liabilities are netted against each other, and the party who is relieved of the net liability is treated as receiving cash in such amount.<sup>3</sup> However, a receipt of actual cash cannot be netted against a receipt of a liability.<sup>4</sup>

<sup>1</sup> Code §1031(d).

<sup>2</sup> Code §1031(b).

<sup>3</sup> Regulation §1.1031(d)-2.

<sup>4</sup> Code §1031(b), Regulation §1.1031(d)-2, Example 2.

Furthermore, notwithstanding the general nonrecognition rule of Code section 1031, depreciation recapture will be triggered on the transfer of depreciable property in a 1031 Exchange except to the extent that the replacement property is not only like kind but also recapture property.<sup>5</sup> Consequently, as a result of the depreciation recapture rules, income may be recognized in a 1031 Exchange even if no boot is received.

### LIKE KIND PROPERTY

The 1031 Exchange applies to property held for productive use in a trade or business, or for investment, if such property is exchanged solely for replacement property of like kind to be held for productive use in a trade or business or for investment.<sup>6</sup> The term "property of like kind" has been interpreted by the courts and the Internal Revenue Service (the "Service"). While the determination of what qualifies as "property of like kind" is highly dependent on the facts and circumstances of each case, certain general principles have been established. The Treasury Regulations (the "Regulations") provide that the qualification of property as "property of like kind" refers to the "nature or character" of the property and not to its "grade or quality."<sup>7</sup> The Regulations illustrate this principle with several examples, including: (1) the exchange of a used passenger automobile for a new passenger automobile qualifies as property of like kind, and (2) the exchange of city real estate for a ranch or a farm also qualifies as property of like kind.<sup>8</sup> Beyond this general principle, the analysis also depends, in part, on whether the assets that are being transferred are real property or personal property.

#### A. Real Property

The 1031 Exchange may include a wide variety of interests in real property.<sup>9</sup> The qualification of real property interests as "property of like kind" requires a two-part analysis. First, the property being exchanged must qualify as "real property" under the law of the state where it is located. Second, the interests in real property that are being exchanged must have the same "nature or character" for federal tax purposes.

##### 1. State Law Definition of Real Property

With respect to the first part of the analysis, state law should control the definition of real property.<sup>10</sup> Under this rule, it may be possible that two very different interests in real property will qualify for a 1031 Exchange, provided that both properties constitute real property under state law. The Regulations state that "[t]he fact any real estate involved is improved or unimproved is not material, for the fact relates only to the

<sup>5</sup> Code §§1245(b)(4), 1250; Regulation §1.1245-4(d).

<sup>6</sup> Code §1031(a). Certain types of property are ineligible for like kind exchanges including inventory, stocks, bonds, partnership interests and choses in action.

<sup>7</sup> Regulation §1.1031(a)-1(b).

<sup>8</sup> Regulation §1.1031(a)-1(c).

<sup>9</sup> Foreign real property is not like kind with real property located in the United States. Code §1031(h).

<sup>10</sup> *Aquilino v. United States*, 363 U.S. 509 (1960); *Morgan v. Commissioner*, 309 U.S. 78 (1940); P.L.R. 8327003 (March 17, 1983) ("For federal income tax purposes, state law controls in determining the nature of the legal interest which a taxpayer has in its property."); *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985). See also Regulation §1.1031(k)-1(e)(3)(iii). An open issue remains with respect to the state law definition of real property. In many states certain interests are treated as real property for some state law purposes while at the same time being treated as personal property for other state law purposes. In such a case, it is unclear which state law characterization would govern.

grade or quality of the property and not to its kind or class.<sup>11</sup> For example, the Tax Court has held that a royalty interest in oil and gas property may be exchanged for a fee interest in land.<sup>12</sup> In this case, the Tax Court found that both property interests were of like kind based on their classification as real property under state law. An exchange of real property may also include unconventional interests in real property. For example, the Service has held that a perpetual water right that qualifies as real property under state law may be exchanged for a fee interest in land.<sup>13</sup>

Interests in real property might also include fixtures and other items of property that are attached to the land, provided that such attachments qualify as real property under state law. The Service appears to take this position, although it has not stated so explicitly. In a series of private letter rulings, the Service ruled that a 1031 Exchange involving real property would include certain items of property which "constitute a fixture under local law."<sup>14</sup> However, the fact that the Service has not explicitly affirmed the view that fixtures are real property for purposes of the 1031 Exchange causes some uncertainty in this area.

## 2. "Nature or Character" of Real Property

The second part of the analysis for exchanges of real property is that the properties being exchanged must possess the same "nature or character." While there is no clear definition of nature or character in this context, the courts have focused attention on the form of ownership and the duration of the real property interest. With respect to the duration of an interest in real property, the courts and the Service have taken the position that interests in real property which have a perpetual duration generally will be treated as property of like kind. According to this principle, a perpetual non-fee interest is treated in the same manner as a fee interest. For example, a perpetual royalty interest in oil and gas property is treated as property of like kind with a fee interest in an improved ranch.<sup>15</sup> However, if both interests in real property are not perpetual interests, then they will not be treated as property of like kind. The courts have held, for example, that an oil and gas production payment right (having a limited duration) differed in nature or character from an oil and gas royalty interest (having a perpetual duration).<sup>16</sup> With respect to leases, long term leasehold interests may qualify as property of like kind with a fee interest. The Regulations provide the example of a 30-year leasehold interest that is treated as property of like kind with other real estate.<sup>17</sup>

The Service has ruled that property is not like kind where the property being exchanged differs substantially in the form of ownership. For example, in a 1986 General Counsel Memorandum, the Service held that a shareholder interest in a not-for-profit agricultural irrigation company, which qualified as real property under state law, could not be exchanged for a fee interest in land. The Service explained that, despite the classification of both assets as real property under state law, they differed substantially in nature and character and, therefore, could not be considered property of a like kind.<sup>18</sup>

<sup>11</sup> Regulation §1.1031(a)-1(c). *See, e.g.*, P.L.R. 9431025 (May 6, 1994) (raw land held for investment was like kind to rental townhouses).

<sup>12</sup> Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941).

<sup>13</sup> Rev. Rul. 55-749, 1955-2 C.B. 295.

<sup>14</sup> P.L.R. 9517005 (January 18, 1995).

<sup>15</sup> P.L.R. 7935126 (June 4, 1979).

<sup>16</sup> Fleming v. Campbell, 205 F.2d 549 (5th Cir. 1953).

<sup>17</sup> Regulation §1.1031(a)-1(c). The leasehold interest, however, must be an interest in real property under state law. *See e.g.*, P.L.R. 8327003 (March 17, 1983).

<sup>18</sup> G.C.M. 39536 (July 17, 1986).

## B. Tangible Personal Property

Tangible personal property may also qualify for a 1031 Exchange if the exchange consists of "property of like kind."<sup>19</sup> While the taxpayer is not prohibited from exchanging items of personal property based on a factual comparison of the nature and character of each asset, the Regulations provide a safe harbor. Under the safe harbor contained in the Regulations, tangible personal property is treated as property of like kind if the property belongs to a "like class."<sup>20</sup> There are two ways that property may qualify as property of a like class. First, the property may be classified within the same General Asset Class, as set forth under the Regulations.<sup>21</sup> Second, the property may belong to the same Product Class, also defined under the Regulations.<sup>22</sup>

### 1. General Asset Classes

As described above, the exchanged properties may qualify as tangible personal property of like class, and therefore as property of like kind, if they are described in the same General Asset Class. The General Asset Classes consist of 13 categories of property. As provided in the Regulations, the General Asset Classes are as follows:<sup>23</sup>

- (i) Office furniture, fixtures and equipment (asset class 00.11)
- (ii) Information systems (computers and peripheral equipment) (asset class 00.12)
- (iii) Data handling equipment, except computers (asset class 00.13)
- (iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21)
- (v) Automobiles, taxis (asset class 00.22)
- (vi) Buses (asset class 00.23)
- (vii) Light general purpose trucks (asset class 00.241)
- (viii) Heavy general purpose trucks (asset class 00.242)
- (ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25)

<sup>19</sup> Personal property used primarily within the United States is not like kind with that used primarily outside the United States. Code §1031(h)(2).

<sup>20</sup> Regulation §1.1031(a)-2.

<sup>21</sup> Regulation §1.1031(a)-2(b)(2).

<sup>22</sup> Regulation §1.1031(a)-2(b)(3).

<sup>23</sup> Regulation §1.1031(a)-2(b)(2); Rev. Proc. 87-56, 1987-2 C.B. 674.

- (x) Tractor units for use over-the-road (asset class 00.26)
- (xi) Trailers and trailer-mounted containers (asset class 00.27)
- (xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and
- (xiii) Industrial steam and electric generation and/or distribution systems which are used for the production of electricity for industrial manufacturing or plant activity and not for sale to others (asset class 00.4)<sup>24</sup>

## 2. Product Classes

Alternatively, tangible personal property may qualify as property of like class if the exchanged properties are described within the same Product Class. Product Classes are generally more specific than General Asset Classes. Under the current Regulations, each 4-digit code listed within Division D of the Standard Industrial Classification Manual (1987) (the "SIC Codes") is a Product Class.<sup>25</sup> Each of the SIC Codes contains a list of assets. If the exchanged property is described within a Product Class, then it is treated as property of like class with any property received which is also listed in that Product Class, and therefore, property of like kind

Recently, the Executive Office of the President, Office of Management and Budget, issued the North American Industry Classification System - United States, 1997 (the "NAICS Codes"). The NAICS Codes consist of a 6-digit code system. The introduction to the NAICS Codes states that the NAICS Codes are intended to replace the SIC Codes for statistical purposes only and that it is up to each governmental agency to choose whether to adopt the NAICS Codes. The Service has informally stated it does not intend to adopt the NAICS Codes in the context of Code section 1031. However, given the resulting uncertainty as to whether the Product Class will be determined under the NAICS Codes or the SIC Codes, the Product Class might not provide a safe harbor. Therefore, in order to proceed with sufficient certainty as to the tax results, it may be necessary to obtain an advance ruling from the Service.

## C. Intangible Personal Property

Intangible personal property may in certain circumstances qualify for a 1031 Exchange. The Regulations state that the qualification of intangible personal property as property of like kind generally depends on (1) the nature or character of the property rights (*e.g.*, a copyright or a patent), and (2) the underlying property right to which the intangible asset relates (*e.g.*, a copyright for a novel or a song).<sup>26</sup> So, for example, the exchange of copyrights relating to different books would qualify for like-kind treatment.<sup>27</sup> Consequently, although, for example, the exchange of licenses or franchises may qualify for a 1031 exchange, concluding that they are like kind will depend on the specific facts. The IRS has recently

<sup>24</sup> This General Asset Class is limited to systems which are utilized in generation and distribution for a taxpayer's own activity and not for sale to others. The Service, on an informal basis, has been unwilling to expand this Class to include generation and distribution systems utilized in the sale of electricity.

<sup>25</sup> Division D of the SIC Manual contains nearly 200 pages of SIC Codes for various manufacturing businesses.

<sup>26</sup> Regulation §1.1031(a)-2(c)(1).

<sup>27</sup> Regulation §1.1031(a)-2(c)(3).

concluded, for example, that an FCC radio broadcast license is like-kind to an FCC television broadcast license.<sup>28</sup> Importantly, the Regulations also state that goodwill and going concern value for one business is never property of like kind with that of another business.<sup>29</sup> A significant issue that has not been addressed by the Regulations and that may be questioned by the Service is the treatment of "goodwill-based" assets, such as those listed in Code Section 197 (customer lists, trademarks).

### EXCHANGES OF MULTIPLE PROPERTIES

A taxpayer may seek to exchange assets which include many different types of property. For example, taxpayers may wish to exchange similar businesses or facilities. For 1031 Exchange purposes, this will not be deemed to be an exchange of a single property but rather as the exchange of the underlying assets of each business (*i.e.*, a multiple property exchange). For a multiple property exchange, the taxpayer is not required to analyze the exchange according to each individual asset. Instead, the Regulations permit the taxpayer to separate the various properties into "exchange groups." Each exchange group consists of property of like kind, as determined under the principles described above. After the exchange groups have been identified, the 1031 Exchange applies to each transfer of an exchange group.<sup>30</sup> For each exchange group, it is necessary to compute an "exchange group surplus" or an "exchange group deficiency." An exchange group surplus is the excess of the fair market value of the assets in such exchange group transferred over that of the assets in such exchange group received. Conversely, an exchange group deficiency is the excess of the fair market value of the assets in such exchange group received over that of the assets in such exchange group transferred. The amount of gain recognized upon the transfer of an exchange group is equal to the lesser of the gain realized (*i.e.*, the difference between the fair market value of the assets transferred and their adjusted tax basis) and the exchange group deficiency. Losses are not recognized.<sup>31</sup>

In a multiple asset exchange, it is necessary to aggregate the liabilities on each side of the exchange. The aggregate liabilities are then netted against each other. The side of the exchange with the net liability then allocates the liability among the exchange groups in proportion to fair market value. In this manner, the transfer of liabilities affects the amount of the exchange group deficiency or exchange group surplus, and the gain realized upon the exchange.<sup>32</sup> Furthermore, as discussed above, depreciation recapture will be triggered on a 1031 Exchange except to the extent the replacement property is not only like kind but also recapture property. If some of the assets transferred in the multiple asset exchange are otherwise subject to depreciation recapture, the Regulations have not addressed how to calculate the amount of the depreciation recapture.

### MULTI-PARTY AND DEFERRED 1031 EXCHANGES

As a practical matter, a simultaneous two-party exchange may not be possible. For example, one party may want to acquire an asset from another party, but the first party may have no asset to exchange. The Code and Regulations provide some flexibility in structuring a 1031 Exchange. First, the exchange of properties in a 1031 Exchange is not required to be simultaneous. Under the Code, a taxpayer may wait as long as 45 days following the initial transfer of the relinquished property to identify the replacement property

<sup>28</sup> TAM 200035005 (May 11, 2000)

<sup>29</sup> Regulation §1.1031(a)-2(c)(2).

<sup>30</sup> Regulation §1.1031(j)-1.

<sup>31</sup> Code §1031(c); Regulation §1.1031(j)-1(b)(3).

<sup>32</sup> Regulation §1.1031(j)-1(b)(2)(ii).

to be received in the exchange. The receipt of the replacement property by the transferor must be completed no later than the earlier of (i) 180 days following the transfer of the relinquished property or (ii) the due date of the tax return of the transferor (including extensions) for the year in which the transfer of the relinquished property occurs.<sup>33</sup> Furthermore, many 1031 Exchanges are accomplished through the use of a qualified intermediary. The qualified intermediary would typically buy the relinquished property from the transferor and sell it to the purchaser for cash and use the cash proceeds to buy the replacement property identified by the transferor and then transfer such replacement property to the transferor. In this manner, the purchaser of the relinquished property is not involved in the transferor's reinvestment in the replacement property and the transferor in the 1031 Exchange would not have access to the cash proceeds from the transfer of the relinquished property, and therefore, the exchange may qualify as a 1031 Exchange.<sup>34</sup>

In order for a deferred exchange to qualify as a 1031 Exchange, the transferor must not receive or have access to cash proceeds resulting from the transfer (*i.e.*, no constructive receipt.) The Regulations contain several safe harbors by which to avoid constructive receipt. For example, the Regulations provide that the cash proceeds from the purchaser of the relinquished property may be subject to a security arrangement, may be deposited with a "qualified escrow agent" (if the acquiror is willing to participate in the exchange) or may be paid to a "qualified intermediary" (if the acquiror is not willing to participate in the exchange). A qualified escrow agent or intermediary generally is someone who is not related to, or was not within the prior two years employed by, the transferor.<sup>35</sup>

The Regulations also contain specific rules dealing with the identification and receipt requirements with respect to the replacement property (including multiple properties), security arrangements, qualified escrow accounts and intermediaries, interest and growth factors and the payment of transaction expenses. There are also issues that may arise as a result of (i) 1031 Exchanges between related parties, (ii) reverse 1031 Exchanges (exchanges where the replacement property is obtained before the relinquished property is transferred), or (iii) the combination of a 1031 Exchange with either tax-free exchanges (*i.e.*, contributions to, or distributions from, corporations and partnerships) or the leveraging, of property.

### CONCLUSION

As discussed above, Code section 1031 permits the deferral of gain or loss that would otherwise be recognized upon a sale or exchange of property. The rules governing the 1031 Exchange are highly fact sensitive, and certain areas of the applicable law are not entirely settled. Therefore, depending on the size of the exchange, it may be desirable to obtain an advance ruling from the Service so that the 1031 Exchange may proceed with a high level of certainty with respect to the tax results.

<sup>33</sup> Code §1031(a)(3); Regulation §1.1031(k)-1(b)(2).

<sup>34</sup> Regulation §1.1031(k)-1(g)(4).

<sup>35</sup> Regulation §1.1031(k)-1(k).

10: Dave Neary  
From: B. by Hall

My comments to follow  
email does. sent to you.

415  
783-  
5 789  
**Memo**

**Deloitte  
& Touche**

Metrolsec Kim - Pitchfork Ranch  
TNC

Date: February 23, 2001

To: Becky Hall, The Nature Conservancy

From: [REDACTED]

Subject: Acquisition of Pitchfork Ranch property from [REDACTED] LLC

The following items were noted upon the review of documents for the contract for sale of the Pitchfork Ranch. This property will possibly serve as replacement property on the disposition of the PK Ranch currently owned by Soldier Creek Preserve, Inc. ("Soldier Creek").

**CONTRACT FOR SALE**

1. The purchaser is listed as The Nature Conservancy ("TNC"). This contract should be assigned to Soldier Creek as the purchaser. IRC §1031 requires that the legal entity that starts the exchange must complete the exchange. This purchase contract will ultimately be assigned form Soldier Creek to a qualified intermediary ("QI") prior to closing. The QI acquires the replacement property (Pitchfork Ranch) with proceeds from the sale of the relinquished property (PK Ranch) and then transfers the replacement property to the exchanger (Soldier Creek) to complete the exchange. However, there should be a trail of assignments from TNC to Soldier Creek and then to the QI. \*
2. The property being acquired includes a long list of items that may or may not apply to this transaction. Please provide a list of all the assets to be acquired and a value attributable to each type of asset. For example if we are acquiring land, building and improvements, farm equipment, etc. please provide a detailed list of the assets and the value assigned to each asset totaling the \$2,872,000 purchase price. In order for Pitchfork Ranch to qualify as replacement property for PK Ranch, it must be considered like-kind property. I have been informed that the majority of the PK Ranch property is real property. As discussed in the memo dated January 17, 2001, attached, personal property is not like kind to real property. Therefore, we must determine what type of property is being acquired in order to determine if it is like kind to the PK Ranch property being sold. \*

see.  
email

**AMENDMENT TO CONTRACT FOR SALE**

This agreement should assign the original contract to Soldier Creek as purchaser and include language that provides for a like-kind exchange in accordance with IRC §1031. The reference to Revenue Procedure 2000-37 is not applicable to this transaction as long as the sale of PK Ranch

Holland &  
Hart  
suggests that  
maybe we  
redraft  
entire agreement  
instead of  
amendment

I'm checking w/  
force of this  
is ok.

precedes the purchase of Pitchfork Ranch. I will provide a sample of appropriate language under separate cover.

**OPTION AGREEMENT**

This agreement should be revoked. Property for which like-kind exchange treatment applies is property that is held for investment or used in a trade or business. Property subject to an option that could be exercised immediately, especially within 2 years of its acquisition, could arguably be held for sale and not held for investment. Property held for sale is not eligible for like-kind exchange treatment. I would not recommend any option be entered into on this property or any other property that will be used as replacement property for the PK Ranch exchange.

discuss  
w/  
Joce

Please contact me at (619) 237-6586 with any questions.

**CONFIDENTIAL  
MEMORANDUM**

October 26, 2001

TO: [REDACTED]  
CC: [REDACTED]  
FROM: [REDACTED]  
RE: Pitchfork Transactions/Wilson Tract

*Metcalfsco Rm - Pitchfork Ranch  
Other Parties*

For the past several years, [REDACTED], LLC ("LHR") and The Nature Conservancy ("TNC") have been working together to protect the Pitchfork Ranch from development. In furtherance of that goal, LHR sold three parcels of land to TNC earlier this year. The "520" was sold in January for just over \$1.5 million. The "320" and "770" were sold in late March for almost \$2.9 million.

These deals were "parking" arrangements, with TNC effectively agreeing to hold the properties for some period of time and then sell them back to LHR or to a conservation-minded buyer. This arrangement was reflected in an option contract on the 520, which gave LHR the right to repurchase that property at any time within two years after the sale for the original purchase price plus cost of funds. If LHR did not exercise its right during this two-year period, TNC had the right for 90 days afterwards to require LHR to buy back the property, again for the initial purchase price plus cost of funds. Although the parties had a similar understanding with respect to both the 320 and the 770, at TNC's request, an option contract was not signed with respect to those parcels.

The parties have recently agreed to another round of transactions, which are expected to close in December. LHR will sell the "Wilson" to TNC in a bargain sale for \$3.5 million and together with [REDACTED] (or an LLC owned by [REDACTED]) will donate conservation easements worth \$1.1 million. LHR will also sell an easement to TNC worth \$200,000, which TNC will pay for with grant money it has already earmarked for that purpose. At the same time, TNC will sell the "Luxford" to LHR for \$370,000. TNC will also sell the 520 to a charitable remainder trust established by [REDACTED] (the "CRT") for \$2 million, nearly \$500,000 more than TNC paid for it. In a related transaction

slated to close in January, TNC will sell the Wilson to the CRT for \$3.5 million.

TNC acknowledges that the economic risk associated with these transactions is small. Indeed, after the December closings, TNC will need to sell the Wilson for only about \$1.9 million to come out even, given the \$1.1 million worth of donated easements and the nearly \$500,000 profit on the sale of the 520. Moreover, if it sells the Wilson for \$3.5 million as planned, it will come out nearly \$1.6 million ahead. And in either case, it will have helped to ensure the conservation of the Pitchfork Ranch. Nevertheless, TNC has expressed concern that the CRT is not legally obligated to buy the Wilson and has asked whether LHR can grant TNC a "put" option to sell the Wilson to LHR in the unlikely event TNC's deal with the CRT falls through.

### **Why can't TNC have an option on the Wilson?**

As we have discussed, granting TNC an option to sell the Wilson to LHR in the unlikely event the sale to the CRT falls through would raise serious tax risks for both LHR and the CRT. LHR is a so-called disqualified person with respect to the CRT and is thus effectively precluded by the self-dealing rules from selling property either directly or indirectly to the CRT. *See* IRC § 4941(d)(1)(A). The risk of self-dealing will be reduced, however, if TNC is a bona fide purchaser of the Wilson, holding both the benefits and the burdens of the property for some period of time before selling it to the CRT. But if TNC eliminates its downside risk with an option, it would be considered nothing more than "straw man" and its ownership for tax purposes would be ignored. In that case, the transaction would be considered a prohibited sale between LHR and the CRT. This would have significant adverse tax consequences, making this deal unworkable.

### **How is this different from the sale of the 520?**

TNC has asked how granting an option on the Wilson would be different from what's already been done with the 520. The critical difference between the two transactions is the parties' intent at the time of the initial purchases. When TNC bought the 520, there was no understanding or expectation that it would later sell the property to the CRT. In fact, the CRT had never even been mentioned as a possible conservation buyer. But there is an expectation that the Wilson will be sold to the CRT, and this expectation alone increases the risk that TNC's ownership will be ignored. Taking away TNC's risk of loss would virtually eliminate any argument that its ownership should be respected.

**Would TNC's tax-status be jeopardized if it sells the Wilson for less than \$3.5 million?**

TNC has also expressed concern that its tax-exempt status could be jeopardized if the sale to the CRT falls through and, to recoup its costs, it ends up selling the Wilson for less than \$3.5 million. Although this is unlikely (in fact, we have difficulty conceiving of the circumstances in which the sale to the CRT would not close), if TNC ends up selling the property for less than \$3.5 million, its exemption should be safe as long as it sells the property in an arm's-length deal for fair market value. A contemporaneous appraisal by an independent appraiser should give TNC added comfort that the transaction will not result in a private benefit or violate the private-inurement or excess-benefit rules.

We hope this answers your questions. Please call if you have further questions or would like to discuss any of these issues.

memo re pitchfork transaction.DOC

Jer [redacted]

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**From:** [redacted] [mailto:[redacted]@tnc.org]  
**Sent:** Friday, October 26, 2001 4:48 PM  
**To:** [redacted]  
**Subject:** RE: memo re pitchfork transaction/wilson tract  
no, please do and print for file

-----Original Message-----

**From:** Jer [redacted] [mailto:[redacted]@tnc.org]  
**Sent:** Friday, October 26, 2001 4:43 PM  
**To:** [redacted]  
**Subject:** RE: memo re pitchfork transaction/wilson tract

[redacted]  
Did you save this memo in the subdirectory? If not, I will do so.

-----Original Message-----

**From:** Becky Hall [mailto:[redacted]@tnc.org]  
**Sent:** Friday, October 26, 2001 4:36 PM  
**To:** [redacted]; [redacted]@tnc.org; [redacted]@tnc.org  
**Cc:** [redacted]@tnc.org; [redacted]@tnc.org; [redacted]@tnc.org  
**Subject:** FW: [redacted] re pitchfork transaction/wilson tract

Hello [redacted] and [redacted]-

I am forwarding the memo prepared by Dave Grandall at Holland & Hart which addresses the "put" and "self-dealing" issue for the Wilson tract in the Pitchfork transaction.

I requested this from [redacted] in order to address our concerns regarding the risk of purchasing the Wilson tract in December without having a contract to resell the property to the CRT in January, as the Board of Governors considers our request for approval for this transaction.

Please let me know if you have any questions-

Thanks,

[redacted]  
Becky

-----Original Message-----

**From:** Peter Pena [mailto:[redacted]@hollandhart.com]  
**Sent:** Friday, October 26, 2001 4:28 PM  
**To:** [redacted]  
**Cc:** [redacted]@tnc.org; [redacted]@jonesday.com; [redacted]@tnc.org  
**Subject:** memo re pitchfork transaction/wilson tract

[redacted]  
As discussed. Please call [redacted] or me if you have any questions.

Have a great weekend!

[redacted]  
Peter J. Pena  
Holland & Hart LLP  
555 17th Street, Suite 3200  
Denver, CO 80202  
Telephone: [redacted]  
Facsimile: [redacted]

10/26/2001

**CONFIDENTIALITY NOTICE:** This message is confidential and may be privileged. If you believe that this e-mail has been sent to you in error, please reply to the sender that you have received this e-mail in error; then please delete this e-mail. Thank you.

o: [REDACTED]  
c: [REDACTED]  
bcc: [REDACTED]  
from: [REDACTED]  
subject: re: FW: PK Ranch Distribution of Earnings & Profits  
Tuesday, June 13, 2000 at 9:50:58 am MDT  
h: [REDACTED]  
certify: N

Bighorn Foothills - PK Ranch  
TNC

li [REDACTED] Thanks for your message.

ctually, I think that I agree with the proposed tax treatment as outlined in the e-mail and memo from Joe, but I had a few questions for him that I just sent to him. As soon as I hear back from him, I'll let you know if there is anything else we should discuss, but for now, let's proceed as if we will follow their advice.

With respect to the Estimated Tax payment, please note that in filling out the payment coupon that you will receive from [REDACTED] today, that the name of the corporation has been changed to Soldier Creek Preserve, Inc. Therefore, I would suggest that you say something like "Soldier Creek Preserve, Inc., formerly known as PK Ranch Company". [REDACTED] said that the most important thing is the FEID # anyway, but we might as well make it crystal clear that we are talking about the same corporation.

After you have received the form from Joe, and the Check Request from Pat, please let me know if you have any questions. In addition, could you please send me a copy of the final form for our files, and I will take care of sending copies to others.

HANKS.

raig T. Neyman@Academy@TNC

I presume your legal judgment is that we rely upon this tax treatment, as proposed by D&T. If so, then my understanding is that all I must do in this regard is to wait by the sidelines until somewhere around March 15, 2001 at which time TNC will receive a K-1 from the PKR S-corp. (for PKR's calendar year 2000) which will show a deemed dividend (debit TNC's investment in PKR) that TNC will have to record on its books and 990 for its FY01 tax year.

Please let me know only if my understanding is incorrect.

Thanks

[REDACTED] -- please use this email and attachment as documentation for a carryforward point for next year's 990 tax prep.

---Original Message---

from: "Joe [REDACTED]"  
mailto:[REDACTED]  
Date: Monday, June 12, 2000 9:18 PM  
Subject: [REDACTED]  
Sent: [REDACTED]  
To: [REDACTED]  
From: [REDACTED]  
Subject: [REDACTED]  
Sent: [REDACTED]  
To: [REDACTED]  
From: [REDACTED]  
Subject: [REDACTED]

SMTP@TNCHQ04@Servers["Tango"]  
Subject: PK Ranch Distribution of Ea. gs & Profits

Please find attached the memo regarding the availability of an Earnings and Profits (E&P) Deemed Distribution for S Corporations. I think this will allow us to distribute the E&P of the S Corporation, thereby relieving PK Ranch of the Excess Passive income issues.

Please call me once you have had an opportunity to review the memo so we may discuss the issues.

Regards,

Joseph M. Egan  
Manager, Tax Services

**Deloitte &  
Touche****Fax Transmission**

**Deloitte & Touche LLP**  
701 "B" Street  
Suite 1900  
San Diego, CA 92131-8198

Telephone: (619) 232-6510  
Facsimile: (619) 232-0955  
www.us.deloitte.com

To:	Company/Office:
<del>XXXXXXXXXX</del>	The Nature Conservancy
Fax Number:	Phone Number:
(303) 541-0346	
From:	Office:
<del>XXXXXXXXXX</del>	Deloitte & Touche LLP - San Diego
Fax Number:	Number of Pages (including this one):
(619) 232-0955	4
Date:	To confirm receipt, or if you do not receive all pages, please call:
6-12-00	<del>XXXXXXXXXX</del> ex <del>XXXXXXXXXX</del>
Comments:	

OK ~~XXXXXXXXXX~~ To take care of tax  
payment 6/13/00  
PR

**Confidentiality Notice:** This page and any accompanying documents contain confidential information intended for a specific individual and purpose. This telecopied information is private and protected by law. If you are not the intended recipient, you are hereby notified that any disclosure, copying or distribution, or the taking of any action based on the contents of this information, is strictly prohibited.

**Deloitte Touche  
Tomatsu**

**Deloitte &  
Touche**

**Southern California/Nevada Tax Services**

**Deloitte & Touche LLP**  
Suite 1900  
701 "B" Street  
San Diego, California 92101-8198

Telephone: (619) 232-3100  
ITT Telex: 4995722  
Facsimile: (619) 232-0955

June 12, 2000

Mr. Craig Neyman  
The Nature Conservancy  
4245 North Fairfax Drive, Suite 100  
Arlington, Virginia 22203

**Re: PK Ranch Corporation**

Dear Craig:

We enclose instructions for payment of the second, third and fourth installment of federal corporate estimated tax for the year ending December 31, 2000. These amounts are based upon your prior year tax liabilities in order to avoid underpayment penalties and interest.

**FEDERAL TAX PAYMENTS:** The following Federal tax payments should be deposited with a Federal Reserve bank or an authorized commercial bank. The payments should be made with Form 8109, Federal Tax Deposit Coupon - Corporation Income Tax, on or before the date indicated. We suggest that you clearly indicate on Form 8109 which year-end (or quarterly estimate) you want the payments applied to. Payments received in the mail by the depository after the due date may be delinquent unless it can be positively shown they were mailed two days prior to the date due.

<u>Type of Tax</u>	<u>Final Date for Payment</u>	<u>Amount</u>
Second Installment - Corporate Tax (F/Y/E: 12/31/2000)	6/15/00	\$4,000
Third Installment - Corporate Tax (F/Y/E: 12/31/2000)	9/15/00	\$1,500
Fourth Installment - Corporate Tax (F/Y/E: 12/31/2000)	12/15/00	\$1,500

At your request, we have included a Form 8109 for your use. The form should be completed based on the instructions above. Please be sure to include the Employer Identification Number for PK Ranch Corporation. Additionally, the Form 8109 must be an original; a Federal Bank may not accept a facsimile or photocopy.

**Deloitte Touche  
ohmatsu**

2235 Faraday Avenue, Suite O, Carlsbad, California 92008-7209  
695 Town Center Drive, Suite 1200, Costa Mesa, California 92626-61924  
1000 Wilshire Boulevard, Los Angeles, California 90017-2472  
50 West Liberty Street, Suite 900, Reno, Nevada 89501-1949  
3773 Howard Hughes Parkway, Suite 490N, Las Vegas, Nevada 89109

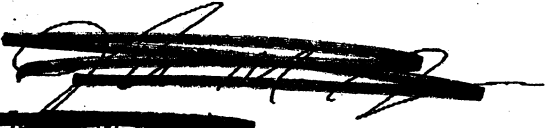
Telephone: (760) 930-3430 Facsimile: (760) 930-3440  
Telephone: (714) 436-7100 Facsimile: (714) 36-7200  
Telephone: (213) 688-0800 Facsimile: (213) 39-0100  
Telephone: (702) 348-8808 Facsimile: (702) 22-8754  
Telephone: (702) 893-3100 Facsimile: (702) 39-1736

June 12, 2000  
The Nature Conservancy  
Page 2

If you have any questions regarding the above, or any other tax matters, please do not hesitate to contact us.

Yours very truly,

DELOITTE & TOUCHE LLP

  
Manager, Tax Services

Enclosures



CC: 



TAX YEAR MONTH →		DOLLARS		TS		TYPE OF TAX		TAX PERIOD	
94		941		34		941		1st Quarter	
990-C		112		990-C		990-C		2nd Quarter	
943		990		943		990		3rd Quarter	
720		990-PF		720		990-PF		4th Quarter	
CT-1		104		CT-1		104			
940				940				35	

EMPLOYER IDENTIFICATION NUMBER →

BANK NAME/DATE STAMP

Name \_\_\_\_\_

Address \_\_\_\_\_

City \_\_\_\_\_

State \_\_\_\_\_ ZIP \_\_\_\_\_

Telephone number ( ) \_\_\_\_\_

IRS USE ONLY

FOR BANK USE IN MICRO ENCLOSURE

## Federal Tax Deposit Coupon

## Form 8109-B (Rev. 10-99)

SEPARATE ALONG THIS LINE AND SUBMIT TO DEPOSITARY WITH PAYMENT OMB NO. 1545-0257

Note: Except for the name, address, and telephone number, entries must be made in pencil. Please use a soft lead (for example, a #2 pencil) so that the entries can be read more accurately by optical scanning equipment. The name, address, and telephone number may be completed other than by hand. You CANNOT use photocopies of the coupons to make your deposits. Do not staple, tape, or fold the coupons.

Paperwork Reduction Act Notice.—We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is 3 min. If you have comments concerning the accuracy of this time estimate or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. DO NOT send this form to this address. Instead, see the instructions on the back of this page.

Purpose of Form.—Use Form 8109-B to make a tax deposit only in the following two situations:

1. You have not yet received your resupply of preprinted deposit coupons (Form 8109); or
2. You are a new entity and have already been assigned an employer identification number (EIN), but you have not yet received your initial supply of preprinted deposit coupons (Form 8109).

Note: If you do not receive your resupply of deposit coupons and a deposit is due or you do not receive your initial supply within 5-6 weeks of receipt of your EIN, please call 1-800-829-1040.

## Types of Tax.—

- Form 941 —Withheld income tax and both the employer and employee social security and Medicare taxes from wages and other compensation (includes Forms 941-M, 941-PF, and 941-SS).
- Form 945 —Withheld income tax from Pensions, Annuities, IRAs, Gambling, Indian Gaming, and Backup Withholding.
- Form 990-C —Farmers' Cooperative Association Income Tax.
- Form 943 —Agricultural Withheld Income, Social Security, and Medicare Taxes (includes Form 943-PF).
- Form 720 —Excise Tax.
- Form CT-1 —Railroad Retirement Taxes.
- Form 940 —Federal Unemployment (FUTA) Tax (includes Form 940-EZ and Form 940-PF).
- Form 1120 —Corporate Income Tax (includes Form 1120 series of returns and Form 2438).

If you have applied for an EIN, have not received it, and a deposit must be made, send your payment to your Internal Revenue Service Center. Make your check or money order payable to the Internal Revenue Service and show on it your name (as shown on Form SS-4, Application for Employer Identification Number), address, kind of tax, period covered, and date you applied for an EIN. Also attach an explanation to the deposit. Do not use Form 8109-B in this situation. Do not use Form 8109-B to deposit delinquent taxes assessed by the IRS. Pay those taxes directly to the IRS. See Circular E, Employer's Tax Guide, for information on depositing by Electronic Funds Transfer.

How To Complete the Form.—Enter your name exactly as shown on your return or other IRS correspondence, address, and EIN in the spaces provided. If you are required to file a Form 1120, 990-C, 941-PF (with net investment income), 990-T, or 2438, enter the month in which your tax year ends in the TAX YEAR MONTH boxes. For example, if your tax year ends in January, enter 01; if it ends in June, enter 06; if it ends in December, enter 12. Please make your entries for EIN and tax year month (if applicable) in the manner specified in Amount of Deposit below. Darken one box each in the TYPE OF TAX and TAX PERIOD columns as explained below.

Amount of Deposit.—Enter the amount of the deposit in the space provided. Enter the amount legibly, forming the characters as shown below:

1234567890

and print money amounts without using dollar signs, commas, a decimal point, or leading zeros. The commas and the decimal point are already shown in the entry area. For example, a deposit of \$7,635.22 would be entered like this:

DOLLARS										CENTS			
								7	6	3	5	2	2

If the deposit is for whole dollars only, enter "00" in the CENTS boxes.

- Form 990-T —Exempt Organization Business Income Tax.
- Form 990-PF —Excise Tax on Private Foundation Net Investment Income.

Form 1042 —Withholding on Foreign Persons.

## Marking the Proper Tax Period.—

Payroll Taxes and Withholding (Forms 941, 940, 943, 941-CT-1, and 1042. See the separate instructions for Form 1042.)

If your liability was incurred during:

- January 1 through March 31, darken the 1st quarter box
  - April 1 through June 30, darken the 2nd quarter box
  - July 1 through September 30, darken the 3rd quarter box
  - October 1 through December 31, darken the 4th quarter box
- Note: If the liability was incurred during one quarter and deposited in another quarter, darken the box for the quarter in which the tax liability was incurred. For example, if the liability was incurred in March and deposited in April, darken the 1st quarter box.

(Continued on back of page.)

TO: [REDACTED]  
FROM: [REDACTED]  
CC: [REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]

Subject: PK Ranch Distribution of Earnings & Profits  
Date: Monday, June 12, 2000 at 7:18:20 pm MDT  
Attach: regsec.doc  
Notify: N

---

Craig,

Please find attached the memo regarding the availability of an Earnings and Profits (E&P) Deemed Distribution for S Corporations. I think this will allow us to distribute the E&P of the S Corporation, thereby relieving PK Ranch of the Excess Passive Income issues.

Please call me once you have had an opportunity to review the memo so we may discuss the issues.

Regards,

[REDACTED]  
Manager, Tax Services

TO: Patrick [REDACTED]  
FROM: Joseph Segoria [REDACTED]  
SUBJECT: [REDACTED]  
DATE: Tuesday, June 13, 2000 at 7:04:02 am MDT  
ATTACH: regsec.doc  
CERTIFY: N

I presume your legal judgment is that we rely upon this tax treatment, as proposed by D&T. If so, then my understanding is that all I must do in this regard is to wait by the sidelines until somewhere around March 15, 2001 at which time TNC will receive a K-1 from the PKR S-corp. (for PKR's calendar year 2000) which will show a deemed dividend (debit TNC's investment in PKR) that TNC will have to record on its books and 990 for its FY01 tax year.

Please let me know only if my understanding is incorrect.

Thanks

[REDACTED] -- please use this email and attachment as documentation for a carryforward point for next year's 990 tax prep.

--Original Message--

FROM: Joseph Segoria [REDACTED]  
SENT: Monday, June 12, 2000 9:18 PM  
TO: Craig T. Neyman [REDACTED]; Patrick Ramos [REDACTED]  
MTP@TNCHQ [REDACTED]; [REDACTED]  
MTP@TNCHQ [REDACTED]; Teresa Young [REDACTED]  
SUBJECT: PK Ranch Distribution of Earnings & Profits

Please find attached the memo regarding the availability of an Earnings and Profits (E&P) Deemed Distribution for S Corporations. I think this will allow us to distribute the E&P of the S Corporation, thereby relieving PK Ranch of the Excess Passive Income issues.

Please call me once you have had an opportunity to review the memo so we may discuss the issues.

Regards,

Joseph M. Segoria  
Manager, Tax Services



## **Memo**

**Deloitte & Touche LLP**  
701 B Street, Suite 1900  
San Diego, CA 92101-8198

Telephone: (619)232-6500  
Facsimile: (619)232-0955  
www.us.deloitte.com

Date: June 1, 2000  
To: The Nature Conservancy - Tax File  
From: [REDACTED] - Tax Senior  
Subject: PK Ranch Distribution

### ***FACTS***

An Internal Revenue Code ("IRC") §501(c)(3) organization, The Nature Conservancy ("TNC") has acquired a 100% interest in an S Corporation, PK Ranch ("PKR"). PKR has a \$0 balance in its accumulated adjustments account ("AAA") and approximately \$600,000 of accumulated earnings and profits ("E & P") from its C Corporation years. In the proposed transaction, PKR desires to distribute to TNC its balance in E & P. PKR does not currently have the cash flows to make the distribution in cash.

### ***ISSUE***

1. What type of non-cash distribution is allowable to distribute the balance in PKR's E & P?

### ***DISCUSSION AND ANALYSIS***

An S Corporation may elect under Final-Reg. §1.1368-1(f)(3) to distribute all or part of its E & P through a deemed dividend. If an S Corporation makes this election, it will be considered to have made the election to distribute E & P first under Final-Reg. §1.1368-1(f)(2).<sup>1</sup> The amount of the deemed dividend may not exceed the E & P of the corporation on the last day of the taxable year, reduced by any actual distributions of E & P made during the taxable year. The

<sup>1</sup> Under Final-Reg. §1.1368-1(f)(2), an S Corporation with accumulated E & P may elect to distribute E & P first. Distributions made by an electing corporation are treated as made first from E & P and second from the AAA. Any remaining portion of the distribution is treated in the manner provided in IRC §1368(b). This election is effective for all distributions made during the year for which the election is made.

amount of the deemed dividend is considered as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

The election to make a deemed dividend is made by attaching a statement to the tax return filed for the applicable taxable year. In the statement, the corporation must identify the election it is making and must state that each shareholder consents to the election. An officer of the corporation must sign under penalties of perjury the statement on behalf of the corporation. The statement must also include the amount of the deemed dividend distributed to each shareholder.<sup>2</sup>

The election to make a deemed dividend is irrevocable and is effective only for the taxable year for which it is made.<sup>3</sup>

### ***CONCLUSION***

PKR may make a non-cash distribution in the form of a deemed dividend to distribute all of its E & P. For the taxable year in which the distribution takes place, PKR must attach to its tax return a signed statement identifying the election it is making under Final-Reg. §1.1368-1(f). Confirmation of consent by TNC, a 100% shareholder, and the amount of the deemed dividend must also be disclosed on the statement.

F:\clients\nature\PK Ranch\RegSec.1.1368Memo.doc

---

<sup>2</sup> Final-Reg. §1.1368-1(f)(5)(iii).

<sup>3</sup> Final-Reg. §1.1368-1(f)(5)(iv).

**Deloitte &  
Touche**



Big Horn Foothills - PK Ranch  
TNC

**Southern California/Nevada Tax Services**

**Deloitte & Touche LLP**  
Suite 1900  
701 "B" Street  
San Diego, California 92101-8198

Telephone: (619) 232-6500  
ITT Telex: 4995722  
Facsimile: (619) 232-0955

December 10, 1999

**VIA FACSIMILE: (303) 541-0346**

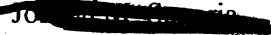
Mr. Patrick Ramos  
The Nature Conservancy  
2060 Broadway, Suite 230  
Boulder, Colorado 80302

Dear Mr. Ramos:

We have reviewed the tax information provided in regard to The Nature Conservancy's acquisition of PK Ranch Company. The attached memorandum details the work performed and our findings relating to this matter.


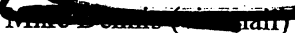
Thank you for this opportunity to be of service to you. Please call me at (619) 231-4505 if you have any questions.

Very truly yours,

  
Manager, Tax Services

Enclosures

cc:

f:/clients/nature/PK Ranch/ltr\_001.doc

*(initials)*

**Deloitte Touche  
Tohmatsu**

2235 Faraday Avenue, Suite O, Carlsbad, California 92008-7209  
695 Town Center Drive, Suite 1200, Costa Mesa, California 92626-1924  
1000 Wilshire Boulevard, Los Angeles, California 90017-2472  
50 West Liberty Street, Suite 900, Reno, Nevada 89501-1949

Telephone: (760) 930-3430  
Telephone: (714) 436-7100  
Telephone: (213) 688-0800  
Telephone: (702) 348-8808

Facsimile: (760) 930-3440  
Facsimile: (714) 436-7200  
Facsimile: (213) 688-0100  
Facsimile: (702) 372-8754



## Memo

**Deloitte & Touche LLP**  
Southern California/Nevada Tax Services  
701 B Street, Suite 1900  
San Diego, CA 92101

Telephone: (619) 232-6500  
Facsimile: (619) 232-0955  
www.us.deloitte.com

Date: November 29, 1999  
To: The Nature Conservancy Tax File  
From: ~~\_\_\_\_\_~~  
Subject: Acquisition of PK Ranch Company

The purpose of this memorandum is to document the tax due diligence work performed by Deloitte & Touche, LLP in connection with the proposed acquisition of PK Ranch Company ("PK") by The Nature Conservancy, a tax-exempt organization under IRC §501(c)(3). We have reviewed the federal income tax returns and other tax-associated documents of PK Ranch Company (as listed in attachment A). Details of the review performed and the findings thereof follow.

### Procedures Performed

In reviewing the income tax returns and other tax-associated documents of PK Ranch, the following procedures were performed:

- Review of the federal and state income tax returns for potential Built-In Gains taxes that would remain the liability of the corporation after the acquisition.
- Review of the federal income tax returns for potential Excess Passive Investment Income Taxes that would remain the liability of the corporation after the acquisition, including review of possible S Corporation termination for Excess Passive Investment Income for three consecutive tax years.
- Review of the federal form 2553, Election by a Small Business Corporation to determine whether the election to be treated as an S Corporation was appropriately completed, including review of IRS acceptance of the form 2553 filing.
- Review of tax returns for any inappropriate accounting methods.
- Review of PK's common and preferred stock books to determine whether PK met the S Corporation shareholder requirements during the S Corporation years, including review of

the demand note from PK to [REDACTED] Trust for the redemption of preferred stock.

- Review of Articles of Incorporation, Bylaws and Minutes of PK for any adverse tax consequences to the corporation that would remain the liability of the corporation after the acquisition.
- Review of various versions of the [REDACTED] Revocable Trust to determine whether the trust was an allowable shareholder of S Corporation stock under IRC §1361(c)(2).

We have reviewed the tax returns provided by the seller and have not reviewed any underlying workpapers.

You have engaged us to conduct a *limited* review of the federal and state tax returns and other tax-associated documents of PK Ranch Company (as listed in attachment A). Consequently, only those review steps described above will be performed. **Deloitte & Touche does not warrant or represent to you that our review steps will enable us to identify every error, potential issue, election, filing, or notice requirement in your returns.** Upon completion of our review, we are reporting to you, the following findings, issues, and questions.

### Federal Income Tax

PK has been an S Corporation since January 1, 1993. If PK is a valid S Corporation as it maintains, then the federal income tax liabilities on the income of the corporation flows through to the S Corporation shareholders. It also means that there are no net operating losses or credits that carryforward to the new shareholders.

The financial statements appear to be maintained on a tax basis. The only book-tax differences reported on the returns for 1993-1998 are meals and entertainment, federal income taxes, and boarding costs limitations. These differences appear to be appropriate. PK's tax advisor maintains that PK has never been audited by the Internal Revenue Service.

### S Election

**One Class of Stock** - PK is a [REDACTED] corporation that was originally incorporated as a C corporation on February 10, 1956. The corporation was initially owned by [REDACTED], [REDACTED], and H. [REDACTED]. Shortly after the incorporation, [REDACTED] sold or transferred his stock in PK to M. [REDACTED]. The remaining stock was subsequently transferred several times between [REDACTED] and [REDACTED] and living trusts established by [REDACTED] and [REDACTED]. It appears that [REDACTED]'s stock was sold or transferred to [REDACTED] during 1970. During 1956, PK issued 2,000 shares of Preferred Stock to [REDACTED]. Per review of the Minutes for the Board of Directors meetings on December 2, 1992, the Preferred Stock was called and retired effective December 31, 1992 at midnight. The minutes detail that the Preferred Stock was redeemed in exchange for a note. The note was a simple demand note for \$212,000, earning an 8% interest per annum. Based on [REDACTED]'s discussions with PK's legal counsel, the note has been paid in full.

According to Treas. Regs. 1.1361-1(l)(3), "in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account." As of December 31, 1992, when its preferred stock was called and retired, PK has only had one class of stock issued and outstanding. Therefore, during its time as an S Corporation, it appears to have met the "one class of stock" requirement.

**Duly Executed S Corporation Election** – We have reviewed the form 2553, Election by a Small Business Corporation ("Election"), and the accompanying IRS Notice of Acceptance as an S Corporation. The Election listed [REDACTED] as the sole shareholder. The share registry supports that the [REDACTED] Revocable Trust was the sole shareholder of PK. Wyoming is a separate property state for property rights purposes, therefore, if the PK stock was [REDACTED] separate property, then only his signature was required for a valid S-Election. If [REDACTED] had an interest in the stock at the time of the election, her signature would be required. We have not confirmed through any other inquiries that the stock was the separate property of [REDACTED] at the time of the Election.

An S Corporation Election must include the shareholders consent with their signature. The sole shareholder of PK is The [REDACTED] Revocable Trust, a grantor trust. Under IRC §1361(c)(2)(B)(i), "the deemed owner shall be treated as the shareholder," and must sign the election. According to IRC §674(a), the grantor shall be treated as the owner of any portion of a trust which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. Therefore, the only required signature of consent for the S Corporation election would be [REDACTED], the deemed owner of the trust who is the sole shareholder of PK.

**Excessive Passive Investment Income** – An S Corporation, that has earnings and profits from C Corporation years, may be subject to a tax under §1375(a) if the S Corporation's passive income for a taxable year exceeds 25% of gross receipts for the year. The tax rate is equal to the highest applicable rate under §11(b), which is currently 35%. Passive investment income is defined to include gross receipts derived from royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities that result in a gain.

[REDACTED], CPA for PK, has represented to us that PK has approximately \$640,000 of earnings and profits. This amount appears to be consistent with the Retained Earnings of PK as reported on the December 31, 1992 federal income tax return. This amount is an estimate, and neither Mr. [REDACTED] nor Deloitte & Touche have performed an earnings and profits study to determine the actual amount. This tax is imposed at the corporate level, and therefore, would be the liability of the corporation and not the shareholder during the tax year the Passive Investment Income is earned.

Included in the 1996 and 1997 returns were "Other Revenues" described as "Water." As these revenues did not appear to exceed 25% of the total gross revenues of PK during the respective years, we did no further analysis whether these revenues are passive investment income.

In the event that PK incurred Excess Passive Investment Income in three consecutive S Corporation years, PK would be deemed to have revoked its S Corporation status effective the

first day of the fourth year.

**Built-In Gains** – Built-in Gains (BIG) tax applies to a C Corporation that converts to an S Corporation after 1986. PK was converted to an S Corporation on January 1, 1993. At the time of conversion, the fair market value of the assets exceeded PK's adjusted tax basis in the assets, creating a BIG. A tax is imposed at the corporate level when a BIG asset that was held at S conversion is sold for a gain during the first ten years after S conversion.

Taxpayers generally obtain an independent appraisal on the value of property held by the C Corporation at the time of S conversion. Based on discussions with [REDACTED], no appraisal was performed. In the event of an IRS audit, the BIG amount reported on its federal tax return would not be supported by an appraisal.

In order to determine the BIG tax liability, the corporation first must determine its net recognized built-in gain for the current tax year pursuant to §1374(d)(2). This limits the built-in gain to the lesser of (a) the built-in gains for the year or (b) the S Corporation's taxable income. Any built-in gains recognized in a tax year that are limited due to the S Corporation's taxable income will be carried forward to the succeeding year (§1374(d)(2)(B)).

During the first seven years beginning with S conversion, PK sold assets for a gain. PK recognized BIG in 1993 of \$677,643. The Built-In Gain was limited to the amount of taxable income of the S Corporation, approximately \$61,337, resulting in \$21,468 of taxes. The remaining BIG (\$616,303) was carried forward. From 1994 through 1998, PK continued to recognize additional BIG on the disposition of C Corporation assets, but did not pay tax on the BIG as PK incurred net operating losses during each of those years.

In total, PK may have recognized approximately \$1.3 million of BIG that it has not paid taxes on due to the net taxable income limitation. This BIG carryforward is the liability of the S Corporation, not the shareholders, and may result in approximately \$455,000 of tax when the BIG is recognizable. This amount may be more, as PK does not have an independent appraisal to support these amounts.

### Other Taxes

**Sales and Use Taxes** – PK has placed approximately \$50,000 - \$200,000 of depreciable property into service in each of the previous 6 years. The gross sales, including sales of breeding cattle, ranged from \$400,000 to \$900,000 per year from 1993-1998. We have not reviewed sales and use tax reports for Wyoming or Kansas.

**Payroll Taxes** – PK has reported approximately \$150,000 - \$200,000 of salaries and wages during each of the previous six years. We have not reviewed the payroll tax reports for federal or state purposes.

The Nature Conservancy  
Acquisition of PK Ranch

**ATTACHMENT A**  
**List of Tax Returns and Supporting Documentation Reviewed**

1998 Federal S Corporation Tax Return for PK Ranch, form 1120S  
1997 Federal S Corporation Tax Return for PK Ranch, form 1120S  
1996 Federal S Corporation Tax Return for PK Ranch, form 1120S  
1995 Federal S Corporation Tax Return for PK Ranch, form 1120S  
1995 Kansas Corporation Income Tax Return, form K-120  
1994 Federal S Corporation Tax Return for PK Ranch, form 1120S  
1994 Kansas Corporation Income Tax Return, form K-120  
1993 Federal S Corporation Tax Return for PK Ranch, form 1120S  
1993 Kansas Corporation Income Tax Return, form K-120  
1992 Federal Corporation Tax Return for PK Ranch, form 1120  
1991 Federal Corporation Tax Return for PK Ranch, form 1120  
Election by a Small Business Corporation, form 2553  
IRS Notice of Acceptance as an S-Corporation  
PK's Common Stock – New Stock Book  
PK's Common Stock – Old Stock Book  
PK's Preferred Stock Book  
Articles of Incorporation, Bylaws and Minutes of PK  
Amended and Restatement of the [REDACTED] Revocable Trust dated July 12, 1996  
Amendment of [REDACTED] Revocable Trust dated March 11, 1997.  
Amendment of [REDACTED] Revocable Trust dated November 23, 1993  
Amendment of [REDACTED] Revocable Trust dated February 25, 1992  
Amendment of [REDACTED] Revocable Trust dated June 20, 1991  
Amendment and Restatement of the [REDACTED] Revocable Trust Dated August 10, 1988  
Amendment and Restatement of the [REDACTED] Revocable Trust Dated May 20, 1988  
Demand Note issued from PK to [REDACTED] in redemption of Preferred Stock.

**Deloitte &  
Touche**Bighorn Foothills - PK Ranch  
TNC**Fax Transmission**Deloitte & Touche LLP  
Southern California/Nevada Tax Services  
701 B Street, Suite 1800  
San Diego, CA 92101Telephone: (619) 232-0600  
Facsimile: (619) 232-0955  
www.us.deloitte.com

To: [REDACTED]

To:	Company/Office:
[REDACTED]	The Nature Conservancy
Fax Number:	Phone Number:
(307) 332-2974	
From:	Office:
[REDACTED]	Deloitte & Touche - San Diego
Fax Number:	Number of Pages (including this one):
(619) 232-0955	11
Date:	To confirm receipt, or if you do not receive all pages, please call:
November 16, 1999	(619) 231-4505
Comments:	
[REDACTED]	

Please find attached the original tax issues summary and calculations sent to Mike Dennis. I have also included revised calculations based on the information, as we understand it to date. Please call me at (619) 231-4505 if you have any questions. Thank You.

**Confidentiality Notice:** This page and any accompanying documents contain confidential information intended for a specific individual and purpose. This telecopied information is private and protected by law. If you are not the intended recipient, you are hereby notified that any disclosure, copying or distribution, or the taking of any action based on the contents of this information, is strictly prohibited.

Deloitte Touche  
AdvisorsTNC buy  
cash

Interest Deductible

The Nature Conservancy  
Purchase of PK Ranch  
11/16/1999 10:07

Interest Deductible

The total property is appraised at \$19M, the Mountain Pasture comprising \$6M of that. PK Ranch grants an easement to The Nature Conservancy (TNC) which reduces the Mountain Pasture property from \$8M to \$3.7M, giving PK Ranch a \$4.3M charitable deduction. PK Ranch sells the mountain pasture to Barry for \$3.7M cash and leaves \$2.8M in PK Ranch. TNC purchases the stock of PK Ranch for \$6M plus the amount of any cash left in PK Ranch.

PK Ranch basis in PK Ranch (per [REDACTED])	1,500,000
Gain on sale of Mountain Pasture	2,700,000
Less: Cash Distributed	(900,000)
Charitable Contribution on Easement	(4,300,000)
PK Ranch basis in PK Ranch prior to Sale to TNC	
Built-in Gain from Sale of Mountain Pasture (per [REDACTED])	3,000,000
Built-in Gain Rate	35%
Built-in Gain Tax	1,050,000
FMV of Total Property	19,000,000
Less: Mountain Pasture	(9,000,000)
FMV of TNC's Property	11,000,000
Purchase Price of Remaining Land	9,000,000
Cash Remaining in PK Ranch	2,800,000
Purchase Price of PK Ranch (basis in stock)	11,800,000
Basis in Stock after Purchase	11,800,000
Less: Distribution (Cash Remaining after BIG Taxes)	(1,750,000)
Basis in Stock prior to Distribution	10,050,000
Gain on Distribution of PK Ranch Property to TNC (FMV)	12,300,000
Basis in Stock after Distribution	23,350,000
Gain on Distribution of PK Ranch Property to TNC (FMV)	13,300,000
Loss on Liquidation of PK Ranch (FMV-Basis)	(10,050,000) @
Net Gain on Liquidation	3,250,000
Less: Carrying Charges (Interest)	(2,300,000) *
Gain/(Loss) on Liquidation	950,000
UBIT Rate	34%
UBIT	323,000
Total Cost of TNC Land	
Purchase Price of PK Ranch	11,800,000
Less: Cash Remaining in PK Ranch before BIG Taxes paid.	(2,800,000)
Built-in Gain Tax	1,050,000
UBIT	323,000
Carrying Charges (Interest)	2,300,000 *
Cost to TNC of Land	12,673,000

\* Assumes property can be sold for the \$11,000,000 appraised value plus carrying charges. Also assumes PK Ranch's tax basis in the property is zero.

Interest calculated at 7.6% of Loan Amount (\$11.8M Purchase Price - \$1.45M Immediate Cash Distribution)

Basis in Stock prior to Liquidation	23,350,000
FMV of Property Received in Liquidation	13,300,000
Loss on Liquidation	(10,050,000) @

45 days i.d.  
(Close w/in  
120 days)

The Nature Conservancy  
Purchase of PK Ranch  
11/16/1998 10:07

## Interest Non-Deductible

The total property is appraised at \$16M, the Mountain Pasture comprising \$8M of that. PK Ranch grants an easement to The Nature Conservancy (TNC) which reduces the Mountain Pasture property from \$8M to \$3.7M, giving PK Ranch a \$4.3M charitable deduction. PK Ranch sells the mountain pasture to Berry for \$3.7M cash and leaves \$2.8M in PK Ranch. TNC purchases the stock of PK Ranch for \$8M plus the amount of any cash left in PK Ranch.

Tax Basis in PK Ranch (per [REDACTED])	1,500,000
Gain on sale of Mountain Pasture	3,700,000
Less: Cash Distributed	(900,000)
Charitable Contribution on Easement	(4,300,000)
Tax Basis in PK Ranch prior to Sale to TNC	
Built-in Gains from Sale of Mountain Pasture (per [REDACTED])	3,000,000
Built-in Gains Rate	38%
Built-in Gains Tax	1,050,000
FMV of Total Property	19,000,000
Less: Mountain Pasture	(8,000,000)
FMV of TNC's Property	11,000,000
Purchase Price of Remaining Land	9,000,000
Cash Remaining in PK Ranch	2,800,000
Purchase Price of PK Ranch (basis in stock)	11,800,000
Basis in Stock after Purchase	11,800,000
Less: Distribution (Cash Remaining after BIG Taxes)	(1,750,000)
Basis in Stock prior to Distribution	10,050,000
Gain on Distribution of PK Ranch Property to TNC (FMV) *	13,300,000
Basis in Stock after Distribution	23,350,000
Gain on Distribution of PK Ranch Property to TNC (FMV)	13,300,000
Loss on Liquidation of PK Ranch (FMV-Basis)	(10,050,000) @
Net Gain on Liquidation	3,250,000
UBIT Rate	34%
UBIT	1,105,000
Total Cost of TNC Land	
Purchase Price of PK Ranch	11,800,000
Less: Cash Remaining in PK Ranch before BIG Taxes paid	(2,800,000)
Built-in Gains Tax	1,050,000
UBIT	1,105,000
Carrying Charges (Interest)	2,300,000 *
Cost to TNC of Land	13,455,000

\* Assumes property can be sold for the \$11,000,000 appraisal value plus carrying charges. Also assumes PK Ranch's tax basis in the property is zero.

Interest calculated at 7.5% of Loan Amount (\$11.6M Purchase Price - \$1.45M Immediate Cash Distribution)

Basis in Stock prior to Liquidation	23,350,000
FMV of Property Received in Liquidation	13,300,000
Loss on Liquidation	(10,050,000) @



*Real Estate Appraisals*

*Brokerage*

*Consulting*

*Management*

N. Clark Wheeler, ARA, Broker  
Certified General Appraiser, MT & WY  
Bozeman Office

Karin T. Franco, ARA, Broker  
Certified General Appraiser, MT & WY  
Sheridan Office

Kim C. Colvin, ARA  
Real Estate Sales Associate  
Certified General Appraiser, MT & WY  
Bozeman Office

Karla E. Naege, Staff Appraiser  
Real Estate Sales Associate  
Bozeman Office

November 10, 1999

The Nature Conservancy - Wyoming  
258 Main Street, Suite 200  
Lander, WY 82520  
307/332-2973 x 3005

[Via Fax ..... (307) 332-2974

RE: PK Ranch

Dear [REDACTED]

I apologize for dropping off the call today. I was having some difficulty with my cell phone. I have not heard back from you so I wanted to follow up on our conversation with a letter and outline some of the issues which we discussed.

A. Conservation easement area.

It sounded as if you and [REDACTED] are having a discussion relative to the amount of restrictions to be placed over the easement area and that perhaps the amount of restriction should be increased so that we can assign a lower after value to the easement encumbered lands. [REDACTED] had discussed the inclusion of public access over the property which would have a substantial diminishing effect on value and which was not part of the valuation criteria which we used in assigning our initial values to this property. Additional restrictions as to buildings and subdivision would also result in additional decreases in value.

All of this relates back to the before value assigned to the property as the percent of diminution assigned as a result of the easement and the after value is governed by the unrestricted value assigned the property. As you and I had discussed previously, there may be some potential to decrease the before value of the property by up to 10%. However, as I described and reiterated to [REDACTED] today, it is not our position in this appraisal process to make up numbers that can be used to fit into the equation. The market value is what the value is, and that is how the IRS will look at the overall transaction. We do not provide a service to anyone by assigning values that are not defensible or can be collapsed by the IRS.

---

221 E. Myndenhall, Bozeman, MT 59712, P.O. Box 1453, Bozeman, MT 59711, Phone: 406/581-7701, Fax: 406/587-2638  
100 North Main, P.O. Box 774, Sheridan, MT 59743, Phone: 406/421-7400, Fax: 406/421-7401

---

ARA - Accredited Rural Appraiser

Obviously it sounds like there needs to be additional discussion relative to the valuation of the overall property and the assignment of the easement diminution. [REDACTED] had inferred that he may be employing an additional Appraiser which could be problematic to the overall process if we have conflicting appraisal reports out there. In view of the overall complexity of this transaction, I believe there is a considerable amount of downside risk which could be complicated by having conflicting appraisal reports. Please advise as to what the status of this process may be.

B. Corporation Valuation

Prior to dropping off the call, I was hoping that you had the opportunity to revisit this issue with [REDACTED] relative to the discount which we would see. We were discussing two different transactions here and two different types of value. One value is specific to the transaction involving The Nature Conservancy and one value would be *Market Value* as defined by appraisal law and the IRS. If we are to appraise a property subject to special conditions or a special users federal law requires the inclusion of extraordinary assumptions within the transmittal letter of the appraisal which basically red flags any valuation work. Typically we appraise market value which is willing buyer/willing seller and under these criteria, corporations which are sold within the market are penalized. I understand that the corporation issue may be resolved in three years. However, there is a three year holding period involved with the property and during that time, it is my understanding that The Nature Conservancy or any other buyer of the property has to physically operate the property. This requires expenditure of a considerable amount of capital relative to purchasing equipment and livestock as well as management oversight. These are issues which a typical buyer would have to consider despite the fact that they may be able to begin to market the property and perhaps contract a sale for the property, now subject to a three year closure.

The bottom line is that conditions such as these place properties into an unusual market arena and within this arena, discounts and alternative or unusual property values are often seen. In many instances, transactions are disregarded as being aberrations of the market when effected by too much special consideration or unusual financing conditions. We need to revisit this issue with the accountants to understand whether or not they believe there would be no red flag on the valuation of a corporation which illustrated no discount. Based on our preliminary numbers, it appears to us you are paying approximately a 20% discount which would probably be appropriate in consideration of the fact the property can be sprung out the other side of the equation in three years.

In our discussions in Wyoming which you and I had, I indicated to you that typically corporation discounts of 30% to 50% are seen in the market. However, these depend on many specific characteristics of the corporation, including debt, type of corporation and holding period required. Our discussions of those numbers was simply to you to help you understand the issues that we must deal with on the appraisal side of the equation.



I feel that it should be clear that we are engaged by the seller to provide an appraisal on the property subject to the easement and market value seen in the market. We have not been engaged to provide any type of a *Special Use or Alternative Appraisal Assignment* that encompasses some of the specific considerations or concerns expressed today. Such a special assignment requires the inclusion or utilization of *extraordinary assumptions or hypothetical conditions* which we are required to disclose under federal law. I trust that it is clear to the parties here that we are providing professional appraisal services based on federal appraisal guidelines. It is not to the benefit of our client to provide valuation information which falls outside the normal constraints of the law thereby allowing the IRS the ability to harass and ultimately extract tax penalties from our client.

I still feel the need for additional conversations related to these valuation issues and the fact that K [REDACTED] needs to be included in these discussions as he has had a substantial amount of information provided to him by you and [REDACTED]. Please call with your thoughts.

Sincerely,

(Dictated but not read.)

N. CHALK [REDACTED]

NCW/ew



-----Original Message-----

From: Andy [mailto:andy@tnc.org]  
Sent: Monday, April 02, 2001 11:33 AM  
To: [redacted]  
Subject: FW: Soldier Creek Preserve 1031 Exchange

Here is [redacted]'s answers to the questions concerning how to calculate the EML for each replacement property identified and coming out of any such replacement property.

-----Original Message-----

From: [redacted] [mailto:[redacted]]  
Sent: Monday, April 02, 2001 9:21 AM  
To: [redacted]  
Subject: RE: Soldier Creek Preserve 1031 Exchange

Andy:

Question 1:

Using the purchase price as the EML is reasonable if you are acquiring the property without any other transaction going on. For example, could there be a bargain purchase element on any of the replacement properties for which the seller is getting part sale and part contribution? If this is the case, then the purchase price may not be representative of fair market value. Do you have any appraisals on the properties to be acquired that indicate a value that is different than the purchase price?

Question 2:

There is no bright line test for a post-exchange holding period, but generally 2 years is preferable. Any disposition, even in another 1031 exchange, could violate the "held for investment purpose test" that is required to be met. I would suggest waiting the two full years or as long as possible, within the two-year time period, to dispose Eastman or any of the other properties purchased as "replacement" property.

Please let me know if you have any other questions.

[redacted]  
[redacted]  
[redacted]  
[redacted]

-----Original Message-----

From: Andy [mailto:andy@tnc.org]  
Sent: Monday, April 02, 2001 9:49 AM  
To: [redacted]  
Cc: [redacted]  
Subject: Soldier Creek Preserve 1031 Exchange

*comment on  
2 yr holding  
period*

[REDACTED]

We have a couple of questions concerning replacement properties for the 1031 exchange.

1. Since we are electing to use the 2002% rule, can we also select the fair market value for each property identified in addition to the legal description, can we use the purchase price as the fair market value or is there some other supporting documentation that we need to have to support the fair market value?

2. Is there any "holding period" for the replacement properties if we wanted to use one or all of the replacement properties to effect another 1031 exchange? For example, if we wanted to sell the Eastman property before January, 2003, could we do another 1031 exchange with it, and if so, is there a period we need to hold Eastman before selling it for another 1031 exchange?

I will be out of the office beginning on Wednesday, April 4th, and not returning to the office until Monday, April 23rd. I will not be checking my e-mail or voice messages during that period so if you could respond to Susan Rodion and [REDACTED] as well as me, I would appreciate it since she will be handling matters related to this 1031 exchange while I am away. For your information, the Identification Statement for the replacement properties will be FAXed to [REDACTED] and [REDACTED] on April 13th and [REDACTED] will FAX you a copy as well.

Thanks for all your help on this matter.

[REDACTED], Division Council  
The Nature Conservancy  
Western Resource Office  
2060 Broadway, Suite 230  
Boulder, CO 80302

[REDACTED]  
[REDACTED]  
[REDACTED]

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# MCCUTCHEN

MCCUTCHEN, DOYLE, BROWN & ENERSEN, LLP

617 - 482 - 5866

## PRIVILEGED AND CONFIDENTIAL

Date: March 15, 2001

~~Direct: (415) 393-2286~~  
~~Fax: (415) 393-2286~~

To: Michael Dennis  
General Counsel  
The Nature Conservancy  
1815 N. Lynn Street  
Arlington, VA 22209

Laurel Mayer  
California Regional Counsel  
The Nature Conservancy  
201 Mission Street, 4<sup>th</sup> Floor  
San Francisco, CA 94105

From: ~~Paul M. McCutchen and Michael Danton~~

Re: Amending Conservation Easements

As you requested, we researched the issue of whether a conservation easement can be amended without jeopardizing its tax-deductible status. In addition, we reviewed the memorandum that you prepared on procedures for The Nature Conservancy ("TNC") to follow when amending conservation easements. We have the following observations and recommendations regarding the amendment of conservation easements.

As you know, the grant of a conservation easement cannot be deducted for federal income tax purposes unless the easement is granted in perpetuity. We understand that in TNC's informal discussions with the Internal Revenue Service (the "IRS"), the IRS has expressed the view that when a conservation easement is amended in a way that reduces the scope of the easement, the easement no longer satisfies this perpetuity requirement and thus loses its tax deductibility. Although we are not aware of any case or ruling directly addressing this issue, we believe that if such an amendment were made to a conservation easement, the IRS would most likely be successful in challenging the tax deductibility of the easement if (i) the amendment was contemplated at the time the easement was originally granted and/or (ii) the landowner did not fully compensate TNC (in cash or other consideration such as additional conservation easements on other property) for the increase in the value of the land to the landowner as a result of the amendment and for any diminution in the value of the conservation easement to TNC as a result of the amendment.

ATTORNEYS AT LAW

Three Embarcadero Center  
San Francisco, California 94111-4067  
Tel. (415) 393-2000 Fax (415) 393-2286  
www.mccutchen.com

San Francisco  
Los Angeles  
Walnut Creek

Palo Alto  
Taipei

In both of these instances, the IRS would have solid grounds for arguing that the original grant of the easement was not made in perpetuity. Furthermore, in the latter instance, TNC would run the risk of violating the tax-law prohibition against conferring a private benefit, and even if the applicable statute of limitations had run with respect to the original grant of the easement, the landowner might nevertheless have to recognize income under the so-called "tax benefit" rule.

We believe, however, that so long as an amendment reducing the scope of a conservation easement (for example, to permit the construction of an additional dwelling on a property) was not contemplated at the time the easement was granted, such an amendment should probably not affect the tax deductibility of the original grant of the easement provided that (i) the landowner fully compensates TNC for the increase in the value of the land to the landowner as a result of the amendment and for any diminution in the value of the conservation easement to TNC as a result of the amendment and (ii) TNC determines that the amendment will not have a significant adverse effect the conservation interests associated with the property.

Provided that full compensation is paid, this approach prevents the landowner from receiving a financial windfall with respect to the original grant of the easement (i.e., because the landowner has fully compensated TNC for the amendment, the landowner has not, in retrospect, received the benefit of an inflated charitable deduction) and also enables TNC not to run afoul of the prohibition against conferring a private benefit. Moreover, as discussed below, we believe this approach also is consistent with the approach taken in the Treasury regulations for dealing with extinguishments of easements and with easements involving the retention by the landowner of certain rights that may impair the conservation interests associated with the property.

The Treasury regulations provide that under certain conditions, a conservation easement can be extinguished without causing the original grant of the easement to fail the perpetuity requirement and thus lose its tax deductibility. One of these conditions is that upon an eventual sale of the property, the donee organization receive a portion of the sales proceeds equal to the proportionate value that the perpetual conservation restriction at the time of the gift bears to the value of the property as a whole at the time of the gift. See Treas. Reg. § 1.170A-14(g)(6). If the donee organization is entitled to be so compensated, then extinguishment of the easement does not cause the perpetuity requirement to be violated.<sup>1</sup> We believe the fact that the Treasury regulations permit extinguishments so long as, among other things, the donee organization is ultimately compensated for the value of the original easement supports the approach we have recommended above for the amendment of conservation easements.

---

<sup>1</sup> We understand that in TNC's informal discussions with the IRS, the IRS has been receptive to the idea of a partial extinguishment. A partial extinguishment might be a useful alternative to an amendment if the Treasury regulations did not require a judicial proceeding to extinguish a conservation easements. We believe this "judicial proceeding" requirement clearly limits the practical use of partial extinguishments (as well as complete extinguishments).

The Treasury regulations also permit a landowner granting a conservation easement to retain rights the exercise of which might impair the conservation interests associated with the property. See Treas. Reg. § 1.170-14A(g)(5). For example, a landowner may retain the right to build additional homes or roads on his property (i.e., rights whose exercise might impair conservation interests) without jeopardizing the tax deductibility of the conservation easement he is granting (though such retained rights could reduce the amount of his tax deduction). Before exercising a retained right, the landowner is required by the Treasury regulations to notify the donee organization in writing. Moreover, the donee organization must have the right to inspect the property to verify compliance with the conservation restrictions, and the right to enforce the conservation restrictions by appropriate legal proceedings. We believe the approach we have recommended for the amendment of conservation easements (i.e., requiring TNC to determine that the amendment will not have a significant adverse effect on the conservation interests associated with the property) is consistent with the approach taken in the Treasury regulations regarding the exercise of retained rights.

When negotiating future conservation easements, TNC may in certain instances want to go to considerable lengths to encourage landowners to consider carefully what specific property rights they want to reserve. Reserving rights at the time of the original gift could avoid the need to amend a conservation easement later. The reserved rights should of course be consistent with the conservation purpose of the easement, and the landowner should understand that retaining rights may reduce the amount of his tax deduction.

Finally, your memorandum states that it is TNC's position that an amendment that places an additional restriction on a property already protected by a conservation easement is no different than placing an additional conservation easement on the property. A recent U.S. Tax Court decision supports this position. In *Strasburg v. Commissioner of Internal Revenue*, the court held that an amendment to an existing conservation easement where the donor was giving up the right to build an additional home on the property constituted a qualified conservation contribution for which the donor was entitled to a deduction. 79 T.C.M. (CCH) 1967 (2000). Under *Strasburg*, a landowner who retained rights at the time of the granting of the original conservation easement should be able to receive an additional tax deduction if he later relinquishes those retained rights to the donee organization.

We hope these observations and suggestions are useful. Please call us if you have questions, and please keep us informed on your discussions with IRS regarding amendment of conservation easements.

JAN-21-97 TUE 9:26

P. 02

SENT BY: Xerox Telecopier 7021 : 1-31-92 : 11:48

~~CONFIDENTIAL - THE NATURE CONSERVANCY~~  
(202) 452-0202

January 31, 1992

**DRAFT**

Michael Dennis, Esquire  
General Counsel  
The Nature Conservancy  
1815 North Lynn Street  
Arlington, Virginia 22209

Dear Mike:

As you requested, we have considered alternative ways in which a combined purchase/donation to The Nature Conservancy could be implemented. This letter presents two alternatives which come within the general outlines we have been discussing for the transaction, and explains the advantages and disadvantages, if any, of each.

Our understanding of the nature of the transaction is as follows. The donor/purchaser, an individual whose legal residence and domicile are in the State of Georgia, has proposed to purchase approximately 75 percent of the property known as the Gray Ranch in New Mexico which is presently owned by The Nature Conservancy. The Nature Conservancy's basis in that land is within the range of \$20-21 million. The donor/purchaser is willing to make a \$15 million commitment to The Nature Conservancy in exchange for the 75 percent interest in the property. As a condition of the conveyance, The Nature Conservancy will place conservation restrictions on the land. Prior to the conclusion of the transaction, a current written appraisal will be obtained to determine the fair market value of the 75 percent interest subject to the conservation restrictions.<sup>1</sup> For purpose

<sup>1</sup> We assume that the appraisal will meet the standards of a qualified appraisal prepared by a qualified independent appraiser. Reg. Treas. Reg. § 1.170A-13(c).

JAN-21-97 TUE 9:27

P. 03

SENT BY: Xerox Telecopier 7021 : 1-31-84 : 11:30

Mr. Michael Dennis  
January 31, 1993  
Page 2

of this letter we assume that this appraised value will be \$X million.

To the extent that the \$15 million commitment exceeds the value of the land subject to the conservation restrictions, the donor/purchaser is willing to make a charitable contribution to The Nature Conservancy of the difference between \$15 million and the appraised value of the land. The \$15 million will be paid in installments, based on a schedule to be set forth in the purchase/gift agreement(s). The donor/purchaser has indicated a willingness to execute promissory notes for the full \$15 million, provided that the note evidencing the charitable contribution does not alter the timing of the deductibility of the donation. The portion of the price allocable to the land will carry interest at the appropriate applicable Federal rate ("AFR"). The portion of the price allocable to the charitable donation will include additional sums to account for the payment of the donation over time.

We think there are two forms that achieve these results and come within these guidelines:

1. Two simultaneous agreements: a purchase agreement for \$X million conveying the 75 percent interest in the land and a separate charitable subscription for \$Y million. The land purchase agreement would be secured by assets acceptable to The Nature Conservancy; the charitable subscription could be unsecured, or secured by acceptable assets (e.g. stock).
2. A single agreement for \$15 million, with \$X million expressly allocated to the land purchase, and \$Y million expressly designated as a charitable subscription. The agreement would be secured for \$15 million by assets acceptable to The Nature Conservancy.

As a preliminary matter, it appears to us that the payment of an amount in excess of the value of the land does not create any automatic problem under the charitable gift rules. Donors commonly engage in "bargain sales," selling property to a charity for an amount less than fair market value. The "bargain" is recognized as a charitable donation, and is deductible by the donor. Our situation is simply the reverse of the bargain sale.

Similarly, in a bargain exchange, donors give valuable property to a charity in exchange for less valuable property.

JAN-21-97 TUE 9:27

P.04

SENT BY: Xerox 1010COP10R 1021 1-31-92 11:00

Mr. Michael Dennis  
January 31, 1992  
Page 3

The Internal Revenue Service (the "Service") acknowledges the deductibility of the excess value given to the charity. Our situation is very similar, except that instead of giving property with an excessive value, our donor will give money in excess of the property's value.

That is the result in another recognized form of charitable giving, the gift annuity. There, a donor purchases an annuity from a charity for a price that exceeds the price of a comparable commercial annuity. The excess payment constitutes a charitable gift, deductible in full in the year of purchase. The gift annuity is analogous to our situation, because an amount will be paid that exceeds the fair market value of the land purchased.

We receive comfort from the fact that the Service recognizes and respects that gifts can occur in combination with an arm's length transaction. No reason occurs to us for dissimilar treatment where the donor receives less than fair market value to dispose of property and where the donor pays more than fair market value to acquire property.

Based on the foregoing, it appears that there is little risk that the Service will refuse to acknowledge the gift portion of a transaction that appears to combine both purchase and gift elements. And as we discussed, the charitable donation will be deductible as payments are made, irrespective of whether the gift is evidenced by a secured or unsecured note and/or subscription agreement.

#### Form 1

By creating separate obligations for the donor, separate agreements may evidence the parties' intention that there are distinct elements of the transaction. It is unclear that any significant advantage is gained since the Service is unlikely to deny that a gift has occurred. Adopting a format to separately establish the gift may be an unnecessary precaution. On the other hand, separate agreements may provide better evidence of the parties' view of the relative value of the land and the charitable gift.<sup>1</sup>

---

<sup>1</sup> There is always a risk that the Service will ignore the form selected, and will recharacterize the transaction in a manner it considers more consistent with the substance of the transaction. For example, even if we execute separate agreements for \$X  
(continued...)

JAN-21-97 TUE 8:28

P.05

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Mr. Michael Dennis  
January 31, 1997  
Page 4

If separate agreements are executed, the land purchase agreement would be supported by a promissory note, containing a schedule of payments and reciting the appropriate AFR interest.<sup>1/</sup> The promissory note should also provide The Nature Conservancy with a security interest in assets acceptable to The Nature Conservancy in the event of default in payment.

We believe the gift should be made in the State of Georgia and that the gift should take the form of a charitable subscription, or pledge, reciting the donor's promise to pay the stated amount. A payment schedule may be set forth. By taking the form of a charitable subscription or pledge, The Nature Conservancy will be in a better position to enforce the pledge. See O.C.G.A. § 13-3-44 (1991) (adopting Restatement of Contracts, 2d, § 90(b) and providing that a charitable subscription is binding under section 90 "without proof that the promise induced action or forbearance").<sup>2/</sup>

Given that charitable subscriptions are enforceable in Georgia, it may not be critical to have the pledge secured. However, securing the pledge with property of similar value

<sup>1/</sup> (...continued)

million and for \$Y million, respectively, the Service may assert that those agreements are actually a single agreement for \$15 million. Thus, there may be no actual advantage to structuring the transaction in this way.

<sup>2/</sup> If the agreement does not provide for adequate stated interest, additional interest will be imputed, and the principal portion of the purchase price will be reduced. Under our facts, that would support an argument by the Service that, in lieu of reducing the principal amount, some portion of the gift should be allocated to the land purchase.

<sup>3/</sup> By contrast, Virginia has not codified the Restatement rule, and its courts have yet to decide whether the rule should be adopted judicially. See Stone Printing and Mfg. Co. v. Dogan, 234 Va. 163, 360 S.E.2d 210 (1987). Moreover, some state courts have rejected the Restatement rule. For example, Maryland courts have refused to enforce charitable pledges absent legislative adoption of the Restatement. Maryland Nat'l Bank v. United Jewish Appeal Federation, 286 Md. 274, 407 A.2d 1130 (1979). In view of the uncertainty under Virginia law, the pledge should provide expressly that it is to be governed by the law of Georgia.

JAN-21-97 TUE 9:29

P. 06

- SENT BY FAX TO THE DIRECTOR OF THE U.S. DEPARTMENT OF THE INTERIOR -

Mr. Michael Dennis  
January 31, 1992  
Page 5

demonstrates the parties' bona fide belief in the relative value of the land and the gift. A security interest also gives added comfort (and may be procedurally simpler) in the event that the donor defaults on the gift agreement.

#### Form 2

As noted, it is doubtful that the Service would deny the existence of a gift simply because a single transaction combines a purchase and a gift. Therefore, there is little reason not to use a single agreement to effect the purchase/gift. The charitable gift would be structured under the agreement as a charitable subscription or pledge to take advantage of Georgia law. As in Form 1, the agreement would carry a promissory note, secured by assets acceptable to The Nature Conservancy and stating adequate interest.

A single agreement for the purchase/gift would have to spell out expressly the parties' intended allocation of the purchase price between the land and the gift. We should note that, regardless of that allocation, there is always the risk that the Service will challenge the appraisal and the resulting allocation, and assert that a greater portion of the \$15 million purchase price is allocable to the land.<sup>1/</sup> While The Nature Conservancy would still be entitled to \$15 million, the donor runs the risk of having a smaller charitable deduction.<sup>2/</sup>

While Form 1 is our preferred form, we are not opposed to either of the formats described.

---

<sup>3/</sup> Since the purchaser and The Nature Conservancy are not related parties, ordinarily the price bargained for by the parties would set fair market value. Where the parties contend that the fair market value is less than the amount being paid, with a gift element constituting the excess, the Service has some room to challenge the allocation of the price between the sale and the gift.

<sup>4/</sup> If the Service successfully contends that the value of the land is greater than \$X million, thereby reducing the charitable donation, the donor's basis in the land would be increased dollar for dollar.

**P. 07**

[REDACTED]



**WILSON & COMPANY, PSC**  
Certified Public Accountants

202 East St. Vernon Street  
Post Office Box 1120  
Somerset, KY 40502

Telephone 606.678-1198  
Facsimile 606.678-0529  
Internet [info@wilco.com](mailto:info@wilco.com)

March 2, 19999

Michael Hatter  
The Nature Conservancy  
642 West Main Street  
Lexington, KY 40508-2018

Dear Mike:

As you requested, we are writing to outline the estimated tax effect of liquidation of Lost Island, Inc. (a Kentucky corporation).

Based on the appraisal letter you furnished and assuming 100% of the value (\$15,000) represents gain to the liquidating corporation and the Corporation has no other assets, liabilities or transactions, the tax liability to the Corporation should be \$600 Kentucky income tax and \$2,250 federal income tax. The total tax should not exceed \$2,850. Our fee for preparation of the return would be \$550 (our minimum corporate tax return fee). We

It may be possible to reduce the income tax somewhat if we can determine the cost of the real estate in the hands of Lost Island, Inc. The estimate we present here should be worst case.

Please contact us if you need additional information.

Very truly yours,

**WILSON & COMPANY, PSC**

[Redacted signature block]



WILSON & COMPANY, PSC  
Certified Public Accountants

One Bank of America Plaza  
Two World Bank Plaza  
Somerset, KY 40367

Telephone: (606) 478-4100  
Facsimile: (606) 478-4100  
Internet: wsc@wsc.com

July 19, 1999

Michael Hatter  
The Nature Conservancy  
642 West Main Street  
Lexington, KY 40508-2018

Dear Mike:

As you requested, we are writing to outline the estimated tax effect of liquidation of Clear Lake Club, Inc. (a Kentucky corporation).

Based on our discussion, the only asset of the corporation is real estate with a fair value of \$350,000 and basis (cost) of \$7,500. Liquidation of the corporation will cause recognition of corporate level gain of \$342,500. The resultant income tax will be approximately \$23,500 Kentucky and \$131,500 federal, for total tax of \$155,000. Our fee for this service is \$10,000. The fee will be paid to The Nature Conservancy.

The tax estimate we have calculated does not consider any other transactions, assets or liabilities that Clear Lake Club, Inc. may have.

Please contact us if you need additional information.

Very truly yours,

WILSON & COMPANY, PSC

[Redacted signature block]

C:\[Redacted]

a) liquidation by TNC

In computing the liquidation tax I made the following assumptions:

fmv of land = \$350,000

cost basis of land = \$7,200, based upon title insurance policy purchased by Clear Lake Club, Inc. in 1953

The liquidation tax is computed as follows:

$\$350,000 - \$7,200 = \$342,800 \times 34\% = \text{liquidation tax of } \$116,552$

TNC has spent \$52,359.80 to acquire 2 shares of the corporation (\$28,193.80--Igert + \$24,166--██████████ Family Trust). TNC will spend an additional \$87,498 to acquire the 3 outstanding shares. TNC's grand total is \$139,857.80 to acquire 5 shares.

This amount does not include direct expenses (legal fees, safe deposit box fees, title insurance, travel related to acquisition, phone, overnight mail, cost of preparing tax return, cost of corporate document preparation and filing, etc.) Mike, refer to the TDR for the direct expenses charged to the project budget center. ██████████ can help you with any overnight mail, postage or copying charges that originated in my office.

Assume that total direct expenses are \$10,000.  $\$10,000 + \$116,552 \text{ liquidation tax} + \$139,857.80 \text{ to purchase the 5 shares not donated} = \$266,409.80$ . This is the estimated amount that TNC should charge the state (plus overhead and interest on amounts advanced to the project, if recoverable.)

Sequence of events - liquidation

1) TNC acquires all shares of Clear Lake Club, Inc.

2) Liquidate:

- prepare corporate legal documents--minutes, resolutions, etc. necessary to appoint new officers and directors, vote to liquidate, etc. ██████████ has started some of this work.
- prepare a final corporate tax return for Clear Lake Club, Inc. showing the liquidation. ██████████ can do this. He should compute the tax--the above amount is my best estimate. TNC will order a check to send to the IRS when tax return is filed.
- sign deed for land from Club to TNC. TNC purchases title insurance policy. Record deed. Sign deed from TNC to state.

3) Deliver deed to state. Pick up check to TNC from state.

### Letter of intent.

Mike, I would like to have [REDACTED] (or other appropriate person) a [REDACTED] sign a letter of intent (or a letter of confirmation accompanied by an invoice, if letters of intent are not used) to confirm that the state will reimburse the following transaction expenses incurred by TNC in order to deliver clear title: cost of purchasing 5 shares, cost of liquidation tax, direct expenses (list them--phone, overnight mail, title insurance, etc.) overhead (if recoverable) and interest (if recoverable.)

We need to document that TNC is not making a profit doing business with a government agency. Because the corporate liquidation tax is an expense TNC must pay, it is not technically part of the cost of the land. If the state prefers a lump sum amount that is fine, but I want the file to document the breakdown.

---

### Timing.

Ideally TNC will spend the \$87,000+ to acquire the additional shares at the same time the state is ready to deliver the check to TNC. Let's discuss the sequence/timing of the state's approval/payment process so we can coordinate spending/reimbursement.

[REDACTED] suggested that TNC attempt to give the 3 remaining share owners a note instead of cash, with a promise to pay the cash as soon as the state reimburses TNC for the land. If any of the remaining share owners are agreeable, this would save TNC interest charges.

#### b) Set up a title holding company.

The second alternative. Under section 501(c)(2) of the Internal Revenue Code, corporations are exempt from tax if they are organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over any income to another tax exempt organization.

TNC could apply for a determination that Clear Lake Club, Inc. is a 501(c)(2) organization. The idea of applying for 501(c)(7) status (pleasure, recreation club) won't fly because TNC cannot show that it is a pleasure or recreation club nor is TNC in the business of pleasure or recreation.

TNC is currently using the 501(c)(2) strategy for other projects. In the other projects, TNC is working to acquire assets of corporations that have already received IRS determination as tax exempt. . Because Clear Lake Club's federal tax status is undetermined, it is a weaker candidate for using this strategy.

In addition, in the Axe Lake project there is enough margin between the fmV and TNC's transaction costs to cover all costs of the project, assuming [REDACTED] is willing to reimburse TNC

for the liquidation tax. This alternative is not available in the other projects. Because TNC has an alternative, Mike prefers to not rely on the 501(c)(2) route.

The steps of the 501(c)(2) route are 1) acquire all shares; 2) apply for 501(c)(2) status; 3) get IRS determination letter; 4) if determined tax exempt, sell land to the state. There would be no tax liability whatsoever. If determined not tax exempt, pay tax, file tax return, sell land to state.

#### Lost Island Club Corporation

TNC will need to follow the liquidation sequence here as well. We need to determine the cost basis of the land. TNC has paid \$5,000 to acquire 1 of 3 outstanding shares, and received ~~the other 2 shares as gifts.~~

Please talk with me about the steps for tracking down corporate records—we have only a copy of the articles of incorporation dated 1965. We need to contact ~~\_\_\_\_\_~~—is there a title policy for Cashe Island? or any other record of what the club paid for the land?

Mike, please set aside some time and give me a call to discuss. ~~\_\_\_\_\_~~  
thanks again for your assistance.

ky/axctax.mcm

Je [REDACTED]

Bighorn Foothills - PK Ranch  
TNC

From: [REDACTED]  
Sent: Monday, April 21, 2003 10:16 AM  
To: dave [REDACTED]  
Cc: c [REDACTED]

Subject: FW: Soldier Creek Preserve

per our conf call this morning, here is the summary of UBIT tax estimates [REDACTED] for SCP--  
I'll follow-up with an email to [REDACTED]

Becky

p.s. [REDACTED] starts maternity leave tomorrow, so please copy [REDACTED] on all WYFO matters/correspondence going forward. [REDACTED] would you please let all of WYFO know?

-----Original Message-----

From: [REDACTED] (San Diego) [mailto:[REDACTED]]  
Sent: Friday, April 11, 2003 3:41 PM  
To: [REDACTED]  
Cc: [REDACTED] (Washington D.C.)  
Subject: Soldier Creek Preserve

Attached are the projected tax calculations on the sale of appreciated assets followed by a liquidation of SCP under various scenarios that we discussed.

Also attached is a memo that outlines the assumptions that we used for the calculations. Please let me know if you require additional scenarios added to the calculations or if you have any questions.

Have a great weekend!

<<assumptions.doc>> <<tax basis calc\_tnc.xls>>

Director  
National Real Estate Tax Services

Deloitte & Touche | 701 "B" Street, Suite 1900 | San Diego, CA 92101-8198

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4/21/2003

# Memo

**Deloitte  
& Touche**

Date: April 11, 2003

To: The Nature Conservancy

From: [REDACTED]

Subject: Soldier Creek Preserve

**Facts:** Soldier Creek Preserve ("SCP"), a wholly owned subsidiary of The Nature Conservancy ("TNC"), is contemplating the sale of certain appreciated assets, to be followed by a liquidation of the corporation. Any remaining assets and liabilities would be distributed to TNC in the liquidation.

Income, gains, losses and deductions that arise from the ownership of an S Corporation by a tax-exempt entity including the disposition of the stock, is considered to be an unrelated trade or business under Internal Revenue Code Section 512(e).

**Issue:** What are the tax consequences to TNC of SCP's present intent to sell appreciated assets followed by a complete liquidation?

**Conclusion:** The attached calculations reflect the tax consequences under various scenarios. The calculations were based on the following assumptions:

- Fair market values of the real property held by SCP was provided by TNC;
- TNC has no other means of sheltering the gains realized from the sale of property and/or the liquidation of SCP;
- SCP has no prior C Corporation earnings and profits;
- All calculations assume that the sales and/or liquidating distributions occur within the same tax year. If the sales and/or liquidating distributions occur in different tax years, the results would materially differ from the calculations presented;
- The tax basis of the stock and the gain on the sale of assets is based on information through December 31, 2001, as information for the tax year 2002 is not yet available. The taxable income or loss (excluding the gain on sale or the distribution of properties) for the period beginning January 1, 2002 through the date of liquidation will impact the stock basis therefore, the actual income tax calculations may differ from the current presentation;

To: The Nature Conservancy

Date: April 11, 2003

- The gains realized on the projected sale of property exclude selling expenses (commissions, etc.) that would be deductible for income tax purposes. As these costs have been excluded from the calculations, the tax amounts are conservative estimates of any actual tax liability;
- All other assets and liabilities (excluding real property) were assumed to have a fair market value equal to the net tax value and therefore no gain or loss was calculated on those items;
- The intercompany liability of \$1,558,224 (as of December 31, 2001) will require repayment before the liquidation of SCP. Alternatively, this amount could be contributed to the capital of SCP. The contribution of the intercompany liability would increase the stock basis and capital loss realized on the complete liquidation of SCP;
- The state tax rate was assumed to be 6%. The federal tax calculation assumes a 34% rate, tax-effected for a state tax deduction;
- If SCP elects not to liquidate, but sells certain appreciated assets, the gain realized on the disposition of the property could be deferred under IRC Section 1031 (like-kind exchange) if replacement property is acquired by SCP under the prescribed time limits.

cc. [REDACTED]

**Per Creek Preserve (FKA "PK Ranch Company")**  
**Estimated Tax Projection Calculation on Various Scenarios**

**Scenario 1**

*No property is sold and all is distributed to TNC in liquidation*

Beginning Tax Basis of TNC (as of 12/31/01)	8,889,161
Total Gain on Distribution - Section 311(b) / 337	12,048,851
Distribution	<u>(13,197,992)</u>
Capital Loss on Liquidation	<u>7,740,020</u>
Gain from Property Sales/Corporate Liquidation	12,048,851
Less Capital Loss on Liquidation	<u>(7,740,020)</u>
Net Capital Gain on Liquidation	<u>4,308,831</u>
Tax on distribution of appreciated property - Section 311(b) / 337	
Federal 34.0%	1,377,102
State 6.0%	258,530
Total Tax	<u>1,635,632</u>

**Scenario 3**

*Like-Kind Exchange*

In this scenario, no property is distributed and SCP does not liquidate. To the extent that there are property sales, like-kind exchanges can be completed to defer the tax, so long as the net proceeds generated from the sale will be reinvested in like-kind exchange property.

**Scenario 2**

*Some properties are sold and the remaining properties are distributed to TNC in complete liquidation*

Beginning Tax Basis of TNC (as of 12/31/01)	8,889,161
Gain on Sale of [REDACTED]	6,205,250
Gain on Distribution of remaining properties	5,843,601
Less Distribution of Sales Proceeds	<u>(6,900,000)</u>
Less Distribution of Property:	
[REDACTED]	(41,992)
[REDACTED]	<u>(1,173,000)</u>
[REDACTED]	<u>(3,300,000)</u>
[REDACTED]	<u>(1,783,000)</u>
Capital Loss on Liquidation	<u>7,740,020</u>
Gain from Property Sales/Corporate Liquidation	12,048,851
Less Capital Loss on Liquidation	<u>(7,740,020)</u>
Net Capital Gain subject to UBI tax	<u>4,308,831</u>
Tax upon Sales of Property/Liquidation -Section 311(b) / 337	
Federal 34.0%	1,377,102
State 6.0%	258,530
Total Tax	<u>1,635,632</u>
Total Proceeds from Sales of Properties	6,900,000
Less estimated UBI tax	<u>(1,635,632)</u>
Net Proceeds to TNC	<u>5,264,368</u>

Melissa Hansen

Pung'alaie - Chancellor  
TNC

From: [REDACTED]  
nt: Friday, September 27, 2002 3:42 PM  
Cc: [REDACTED]  
Subject: Chancellor Memo



542319-1\_.doc



Static copy of  
MMoreheadBPierc...

Hello all-

Attached below is an updated memo (542319-1\_.1.doc) from our outside counsel, [REDACTED] at Isaacson, Rosenbaum, Woods & Levy in Denver, which addresses some of the outstanding tax, securities, and real estate filing issues for the Chancellor project, which is coming before the Board of Governors next week. I have also attached below a prior memo (Static copy of [REDACTED]) from [REDACTED], dated May 23, 2002 which addressed several of these matters.

I think the memo fairly reflects the law and a reasonable interpretation thereof; however, I believe that there are two areas which could use more emphasis in consideration.

The first is the issue of "re-assemblage" of the individual lots after all development rights have been extinguished. As [REDACTED] notes in the memo, there are concerns both from a securities and a tax perspective regarding the possible sale of tax credits under the Colorado tax credit statute. The gray area exists in determining whether there is any pre-conceived expectation or notion of re-assemblage, and I urge to consider carefully how [REDACTED] may be interpreted or perceived.

The second area involves registration with the Colorado Real Estate Commission. It is my understanding that sales of 20 or more lots (whether in one or several phases) requires such registration. The registration form is not difficult but it does require disclosure of certain matters by the principals of the applicant - i.e. The Nature Conservancy, a District of Columbia nonprofit corporation - not just the local field office. I raise this because I recall this was an issue for the TNC principals when we were considering an application for a Colorado liquor license at the Medano-Zapata, and such application required similar disclosures.

Both [REDACTED] and I are available Monday if you have any concerns concerning this memo.  
Thanks-  
Becky

ANTON D. ROSENBAUM  
A. WOODS  
EL L. LEVY  
STEVEN G. WRIGHT  
RICHARD D. GREENGARD  
EDWARD T. RAMEY  
WILLIAM M. SILBERSTEIN  
LAWRENCE J. DONOVAN, JR.  
GARY LOZOW  
LAWRENCE R. KUETER  
JONATHAN H. STEELER

SHELDON E. FRIEDMAN  
MARK G. GRUESKIN  
GARY A. KLEIMAN  
JON R. TANDLER  
BARRY PERMUT  
RICHARD M. PETKUN  
NEIL B. OBERFELD  
ROBERT L. CONNELLY, JR.  
JOHN A. CHANIN  
THERESA L. CORRADA  
PAMELA A. JOHNSON

BLAIN D. MYHRE  
MELISSA K. THOMPSON  
LISA D. L. WILLIAMS  
DEREK C. WEST  
LISA R. BRENNER  
RICHARD A. HARDAWAY  
BRADLEY A. BECK  
LISA C. WALTER  
BONNIE LARSON-DE PAZ  
KELLY ELEFANT  
CHRISTINE L. HAYES

MATTHEW D. PLUSS  
MELINDA M. BECK  
ELIZABETH M. LETZSCH  
JULIE L. SPIEGLEMAN

LOUIS G. ISAACSON (1910-1993)  
CHARLES ROSENBAUM (1901-1973)  
SAMUEL M. GOLDBERG (1903-1974)  
JOSEPH J. STOLLAR (1946-1984)

TIMOTHY P. DALY OF COUNSEL  
PAUL V. FRANKE SPECIAL COUNSEL  
SANDY GAIL NYHOLM OF COUNSEL

## MEMORANDUM

TO: [REDACTED]

CC: [REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]

FROM: [REDACTED]

DATE: September 27, 2002

RE: May 23, 2002 Memorandum re Availability of Colorado Conservation  
Income Tax Credits

You have asked us to expand on several issues related to the May 23, 2002 memorandum that I wrote to you re "Availability of Colorado Conservation Easement Income Tax Credit In a Southeast Colorado Limited Development Transaction." A copy of the May 23, 2002 memorandum is attached and should be read in conjunction with this memorandum.

Prior to addressing those issues, I want to discuss a September 20, 2002 Internal Revenue Service National Office Legal Advice Memorandum for Area Counsel which raises, but does not answer, several issues regarding the Colorado income tax credit for the donation of a conservation easement. The first and most significant issue raised is "whether, to the extent a taxpayer is effectively reimbursed for the transfer of the easement through the use, refund, or transfer of the credit, that benefit is a *quid pro quo* that reduces or eliminates a charitable deduction under § 170." An affirmative response to this question would throw the availability of the Colorado income tax credit into some confusion because of House Bill 02-1098, passed this year by the Colorado Legislature. It requires that for a Colorado income tax credit to be claimed the conservation easement must also qualify as a qualified conservation contribution under Section 170(h) of the Internal Revenue Code and the applicable Treasury Regulations.

The remainder of the legal Advice Memorandum raises questions about whether the credit received results in a capital gain to the donor of the conservation easement and related

September 27, 2002

Page 2

issues. These remaining issues, while not going to the very availability of the credit as does the first issue discussed above, could have a material effect on the economics of a transaction involving the credit. The office issuing the Legal Advice Memorandum has recommended that the questions it has raised be addressed in published guidance, which would have to be approved at higher levels of the Internal Revenue Service.

### **Consequence of Purchase of a Parcel by a Board Member**

The first question asked was whether a board member of the Colorado chapter of The Nature Conservancy could purchase one of the proposed parcels. We believe that with appropriate cautions, a board member could do so. A tax-exempt organization is not prohibited from selling an asset to an insider such as a board member, provided it is at a fair and reasonable price without special concessions not offered to the general public. One could anticipate, however, that added scrutiny would be applied in that type of circumstance. That requires that the parcels be appraised carefully so that the sale values can be defended, whether that sale is to an insider or to a member of the general public. An additional consideration may be that a board member who believes it is reasonably likely that they would participate in this project by the purchase of a parcel, may want to recuse themselves from the review and approval of the structure of the project, and should certainly recuse themselves from the process of valuing and setting sale prices for the various parcels.

### **Further Description of the "Collapsing of a Transaction" and Additional Discussion Regarding Reassembly of the Property**

It should be expected that the structure of this transaction will be reviewed as to its "substance" and not as to its "form." That means where additional steps are created in a transaction for no reason other than to generate a tax benefit, or where there are elements of a transaction for which there is no underlying economic reality, additional scrutiny of the transaction would look past those items to the substance of what really occurred. A donor of money to The Nature Conservancy who only receives title to the property temporarily in order for them to place a conservation easement and therefore generate a tax credit, before allowing The Nature Conservancy to reassemble the property, includes a step (the transfer of title) which occurs for no reason except to generate the tax credit. Conversely, a sale of a parcel to a "buyer," where the paper trail is clear that it is their intention to be a buyer of property and not just a donor of money, would naturally include the step of transferring title to property. This relates to my prior caution that "prospective parcel owners should be approached as 'buyers' and not as 'donors.'"

In giving additional thought to a right of reassembly and whether that was possible, I am still nervous about formalizing a reassembly plan. If a right of repurchase can be exercised after a parcel owner has made the donation of a conservation easement, it would give credibility to the characterization that this was simply a "loan" of the property to a party to generate tax credits. If a right of repurchase exists which could be exercised to prevent a purchaser from

September 27, 2002

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building a home, it contradicts the position that purchasers are free to either build a home or donate a conservation easement. I would be concerned about these issues regardless of whether it was a contractual right of repurchase or something less direct, such as the ability to walk away from the property before a balloon loan payment was due on a loan from The Nature Conservancy.

A better program of reassemblage might be not to raise the issue during this first stage of the project. A purchaser of a parcel who donates a conservation easement and eliminates any building right does have property which is of limited use to them. Following those events, they may approach The Nature Conservancy on an unprompted basis that they prefer not to retain title. A suggestion at that time that the fee title could be donated to The Nature Conservancy or a donation could be provided for in their will may accomplish almost as much as a right of repurchase, without the possible taint on the structure of the transaction.

#### **Unrelated Business Income**

You have asked that we advise you about our view of whether the sale of these parcels would create unrelated business income for The Nature Conservancy. For such income to be from an "unrelated" trade or business it would have to be "not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance" of the organization of its charitable purpose. Our belief is that you can make a good case that the sale of these parcels is substantially related to the charitable purpose of The Nature Conservancy. That position can be enhanced if the sale of the parcels is a part of the land preservation project and not just a manner of raising money for it. Tying the conservation values of the parcels to the conservation values of the whole project, specifying the location of the building envelopes, and the creation of a community, albeit it limited in size, that helps monitor and foster the conservation values of the property, would all be helpful in establishing that substantial relationship.

A second consideration regarding this issue should be whether any income is actually going to be generated by the sale of these parcels. Allocating the purchase price of the project to specific parcels to determine a basis for each parcel is important. If they are not sold at a value higher than that basis, then it may be that no income is realized.

#### **Securities Law and Colorado Subdivider Requirements**

We have been asked to advise whether we believe the proposed structure of this transaction, now described to us as eighteen (18) or nineteen (19) parcels initially with the potential of another 18 or 19 parcels in a distinct second phase, causes any concern regarding securities issues. The definition of a security is a common scheme, with an expectation of profit, based on the reliance of the actions of others. It does not seem to us that the sale of the parcels would fall within that definition. However, the fact that this is the sale of real property on an

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individual parcel basis does not settle the issue. We assume that the marketing of these parcels will not include any communication which would create an anticipation for an increase in value of the properties because of the actions of The Nature Conservancy. As an example, marketing these properties as "great investments, which will increase in value because they will be next to permanently-protected open space owned by The Nature Conservancy" could result in crossing the line from sales of individual parcels of property to individual purchasers, to a common scheme of sales with an expectation of profit based on actions that The Nature Conservancy is going to take.

We have not been asked to address any issues of registration as a consequence of the sale of these parcels, but would like to briefly comment. C.R.S. § 12-61-401, *et seq.* requires registration as a subdivider for the sale of twenty (20) or more parcels. There is no stated exemption for doing more than twenty in distinct phases. Therefore, the conservative course of action, because a violation is a Class 6 felony, will be to register. The Interstate Land Sales Act exempts sales of less than twenty-five (25) parcels from the provisions of the Act, and exempts less than one hundred (100) units from registration but not from its advertising and marketing requirements.

### **How to Market the Property**

We have also been asked about our thought regarding the marketing of these parcels regarding the choices of constructing the home which would be permitted within each parcel versus the donation of that right by the imposition of a conservation easement. This is an area where I believe that extra caution must be exercised. I believe it is acceptable to inform people of the choices that they have as the purchaser of one of these parcels. Those choices include building a home, donating a conservation easement and eliminating the right to build, or doing neither. It is essential that there is no expectation communicated verbally or in writing to the lot purchasers that there is an obligation, albeit moral and not legal, to donate the conservation easement and eliminate the ability to build a home. The lot owners must have the right to make an independent, uncoerced, decision regarding their choice to build or donate a conservation easement. The Nature Conservancy must have only one position regarding this, and not an "official" position and "unofficial" position. If the latter exists, a good lawyer in a deposition will bring it to light, and this structure then looks like a tax scheme and not a valid limited development proposal. That will reflect badly on The Nature Conservancy whether or not it has violated the letter of the law.

### **Concluding Thought**

Both this and my prior memorandum have dealt primarily with the legal standards regarding the proposed structure of this transaction. But some comments transcend just the legal issues and include consideration of how the transaction is perceived by others. That bears directly on the credibility and integrity of The Nature Conservancy and is as important as the

ISAACSON, ROSENBAUM, WOODS & LEVY, P.C.

**[REDACTED]**  
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initial legal question posed to us. This transaction can be properly handled and be a legitimate limited development transaction. But, if it is a transaction with a hidden agenda regarding the sale parcels, that hidden agenda will become known and this transaction will be perceived as an attempt to use Colorado income tax credits to fund a project of The Nature Conservancy.

/cal

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## MEMORANDUM

TO: [REDACTED]

CC: [REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]

FROM: [REDACTED]  
May 23

DATE: September 27, 2002

RE: Availability of Colorado Conservation Easement Income Tax Credit In a Southeast Colorado Limited Development Transaction

The purpose of this memorandum is to provide our preliminary advice to The Nature Conservancy regarding the availability of the Colorado income tax credit for the donation of conservation easements in a proposed transaction in southeast Colorado.

### TRANSACTION SUMMARY

My conceptual understanding of the transaction is that it involves up to approximately 190,000 acres in southeast Colorado. While the bulk of the property would be protected and no development permitted, as a means of assisting in the financing for the purchase of the property, approximately 36-40 parcels of 320 acres each would be sold to individual buyers. Each of those parcels would contain a two-acre building envelope on which could be constructed one single-family house and accessory structures, and the parcels would be generally clustered along existing county roads, so that new roadways would not be required for accessing any of these parcels.

The parcels would be sold initially to a selected group of people with the hope that some them would be sufficiently conservation-minded that they would donate a conservation easement over their parcel which would eliminate the permitted house site. However, there would be no contractual requirement for them to make such a donation.

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The issue we have been asked to review is whether a donor of a conservation easement in these circumstances would be eligible for the Colorado income tax credit for the donation of a conservation easement.

### CONCLUSION

Our general conclusion is that a Colorado income tax credit should be available to a donor of a conservation easement on one of the proposed parcels where that conservation easement eliminates the ability to build a home. This conclusion is predicated on the assumption that the donation (presumably back to The Nature Conservancy) is done freely, out of disinterested generosity of the parcel owner, and not by requirement (either express or clearly implied). This conclusion is subject to several cautions discussed below.

### ANALYSIS

#### Comparison to Limited Development Transactions.

Setting aside the issue of the subsequent donation of a conservation easement on each of these parcels, this transaction could be fairly characterized as a limited development conservation transaction. It has all of the elements of that kind of transaction: a large parcel of property; protection of substantially all of the property except for a limited area of development; clustering of the development that is permitted; and use of the development values to help finance a purchase of the property, the bulk of which is protected.

A general cause of concern in the conservation community regarding conservation easement transactions and the Colorado income tax credit has been the proposed division of an entire property into multiple parcels in order to generate multiple tax credits. That type of proposal is inconsistent with the spirit of the Colorado conservation easement income tax credit law, even if it is not clear whether it violates the letter of the law. Such a transaction would result in the complete division of the property into multiple parcels with each parcel intended to generate an income tax credit.

The difference between that kind of transaction and a limited development transaction is that in the former the division of the property is solely motivated by the desire to obtain multiple tax credits. In the limited development scenario, multiple ownerships are created to create value to purchase a larger parcel, all of which is protected except for the small area within which the development can occur. We believe that a subsequent conservation easement on a development parcel within a limited development project can be consistent with the letter and the spirit of the Colorado law regarding conservation easement income tax credits, subject to the important cautions noted below.

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#### Orchestration of Donations.

The manner in which the possibility of a subsequent donation of a conservation is communicated and encouraged for the perspective parcel purchasers is very important. How this is "pitched" to those purchasers can bear on the issue of the validity of the tax credit. If The Nature Conservancy finds 40 potential donors for this project, each of whom is willing to donate \$100,000 in cash, as an example, and then each was convinced instead to buy the parcel and make the conservation easement donation (where their effective donation would be the same, but their larger initial expense would be offset by a Colorado income tax credit), it would seem like an orchestrated deal to generate tax credits as opposed to the limited development transaction described above.

While it may sound strange, it will probably actually solidify the ability of these parcel purchasers to generate the Colorado income tax credit if several parcel purchasers decline to make the donation and actually construct a unit in the location permitted. That kind of action would be the clearest evidence available that a parcel purchaser was making an independent donation decision and rebut any claim that the donations were orchestrated.

With regard to the possibility of "orchestrating" donations, I believe that it would be prudent to think about this in terms of letting parcel owners know that The Nature Conservancy would be delighted if they donated a conservation easement to prohibit development on the parcel they purchased, while letting them know that it is their decision whether to make such a donation, and there would be no official or no unofficial consequence for not doing so.

#### Independent Transactions.

An additional matter to consider is that you will want to have each of these donations done independent of any other conservation easement donation, i.e., have each be free-standing. That would reinforce the notion that each of these conservation easement decisions is an independent donation decision of each parcel purchaser.

When making the donation of a conservation easement for a Colorado income tax credit, as a result of H.B. 02-1098, it is necessary for the conservation easement to comply with the Internal Revenue Code and the Treasury Regulations. That requires that each conservation easement also stand on its own from the standpoint of the analysis of the conservation purposes of each. Those conservation values will need to be specifically identified in each easement.

#### Valuation Issue.

Related to that is the question of valuation in terms of what is the value that a donor would be giving away by eliminating the ability to build a single-family and accessory structures within a 2-acre building envelope. Assuming that the restriction to a 2-acre building envelope at the time of sale will be by deed restriction, an appraiser will be aware that each individual parcel is already subject to such a restriction. From an appraisal standpoint, it may not be viewed that

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any value of consequence is being donated by the conservation restrictions on the portion of the 320 acres not within the building envelope, and that the only real value being donated is the right to build within the building envelope.

It may be prudent to engage an appraiser early in the transaction to discuss conceptually how they would view a conservation easement over a property that is already deed restricted in a manner generally consistent with the conservation easement except for the elimination of the building envelope.

#### Reassemblage.

In our initial discussion, some thought was given to whether The Nature Conservancy could retain a right of first refusal or other right of repurchase as a means of retaining additional control over the parcels after their initial sale. After further reflection, I do not believe that would be prudent. A right of repurchase (and thus the power to reassemble the property) will make this look as though the parcels were solely being transferred for the creation of the income tax credit. I do not believe that is consistent with the spirit of the law and it could be a transaction that is "collapsed," i.e., looking past the form of a transaction to its substance, and perceived as a "loan" of property solely to generate tax credits.

#### General Comments.

Having advised you above that our conclusion is that this transaction can be successful in generating Colorado income tax credits for the donation of conservation easements, these additional cautions also should make clear that how you go about it could affect that validity. As a general matter, I would look at this transaction as a limited development project that will be successful in protecting 190,000 acres, even if each of the 36-40 parcels gets developed with a homesite. That is an extraordinarily small amount of limited development given the size of the property and could stand alone as a successful conservation project. With that premise, each time that a parcel purchaser makes a donation of their development right, it would be perceived as a bonus that increases the conservation value of the project, but it is not essential for its success. This attitude would correlate well with my feeling that this transaction, both in reality and perception, must be one where the individual parcel purchasers did have the discretion to make or not make the donation of a conservation easement.

In reviewing this issue, we have not analyzed the question of whether the sale of these parcels creates unrelated taxable income for The Nature Conservancy. For obvious reasons, that issue should be resolved as well.

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Summary.

A summary of some of the important cautions is as follows:

- Keep the donation decision an independent decision of the parcel owner.
- Do not create or plan for a "reassembly" right.
- Provide "information" but not "pressure" regarding the conservation easement donation decision and its income tax credit for the parcel owner.
- Prospective parcel owners should be approached as "buyers" and not as "donors."
- Do not "orchestrate" the donation decision in any way, i.e., do not have an "official" position on the structure of the transaction and an "unofficial, off-the-record" version.
- The transactions need to be about selling land and not selling tax credits.
- Be sure there are identifiable conservation values for each parcel to satisfy Internal Revenue Code requirements.

The difference between a limited development project with independent donation decisions and an orchestrated tax credit deal could get fuzzy if these cautions are ignored. If the cautions are observed, the income tax credits should be available to a parcel owner who subsequently donates a conservation easement.

April 21, 2005  
Senate Finance Committee Letter

Question 5

**Please provide information regarding whether TNC ever entered into any property acquisitions or dispositions for which Colorado conservation tax credits were claimed by a party to the transaction. Specifically, did TNC execute or participate in transactions in accordance with the opinions of May 23, 2002 and September 27, 2002 from Isaacson, Rosenbaum, Woods & Levy on the Colorado conservation tax credit. If so, please provide all the information for each transaction as was requested above in question 1 for the conservation buyer program.**

The Conservancy did not execute or participate in the specific transaction referenced in the letters from Isaacson, Rosenbaum, Woods & Levy described in the question above. The project that was contemplated never materialized because the Conservancy made an affirmative decision not to proceed with the acquisition of the property both for reasons identified in the letters and because of a difference of opinion with the seller about the market value of the property. The Conservancy sought the outside legal advice and expertise on the issues discussed in the letter in order to help the Conservancy fully assess the pros and cons that would be faced in the event that it decided to proceed with such a project strategy. Having been presented with the analysis of various considerations in the project, the Conservancy chose not to proceed further. (Please note that approximately one year after the Conservancy withdrew from the project, the State of Colorado, acting through its State Lands Board, acquired the subject property.)

To the best of the Conservancy's knowledge, there are no other Conservancy transactions in Colorado where the Conservancy acquired property in bulk and then resold all or portions of the property with a plan to have buyers maximize state tax benefits. There are however, numerous Colorado projects where the Conservancy has been the donee of conservation easements or lands that advance recognized conservation priorities. In some of those cases, donations are made over a number of years based on the landowner's own personal situation and considerations, to which the Conservancy is not privy. In each year of a multi-year donation, however, the Conservancy evaluates the merit of that year's donation so that each easement has ecological value on its own that is not dependent on completion of future donations. In most cases, the landowners who make such conservation gifts are motivated to do so, in part, because of the tax benefits that accrue in connection with such donations. In Colorado, as is the case elsewhere, the Conservancy follows its internal procedures with respect to not providing tax advice to landowners with respect to the actual tax treatment for or results from a particular conservation transaction.